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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

NOVEMBER 1985

Happy Birthday

Notwithstanding all the skepticism that greeted its arrival, as well as the consistent underestimation of its strength and staying power by a number of economists, businessmen and politicians, the current economic expansion has now achieved a milestone of sorts. November marks its third birthday, and if it runs beyond yearend as it seems likely to do, it will become the third-longest post-World War II peacetime expansion. That's not bad for an upswing that many have called weaker than normal and which some economists even wrote off completely earlier this year.

In spite of this impressive track record, there remains considerable confusion and uncertainty over the current and future state of the U.S. economy. A number of economists believe that growth in the current quarter will be much less than that of the third, and of those who don't, many believe that the expansion will run out of steam sometime next year. The October 1985 Economic Report spells out our view of the economy, near-term through yearend 1986, and the reasoning behind it, so I won't go into that aspect here. What I thought might be appropriate, in view of the occasion, is a comparison of the current upswing with its predecessors to see if any further insights into the future can be gleaned.

A Comparison With The Past . . .

As the table inside indicates, the gain in the gross national product adjusted for inflation has, indeed, been weaker than average. In fact, it has been weaker than average in almost every quarter since it began. What is more, the gap between the current expansion's GNP path and those of its predecessors has been widening in the last year.

However, this includes wartime periods, which tend to prolong expansions. A comparison with peacetime upswings only produces a more favorable result. What is more, the real GNP is only one way of measuring the state of business. As its name implies, it describes the output side of the economy. Another way to look at things is through the spending side and here the comparison is quite different. Domestic demand adjusted for inflation grew slightly less than average over this recovery's first year of life—but starting in first-quarter 1984 it has been consistently stronger and is now well above the postwar peacetime average. Of course, the difference between real domestic demand and the real gross national product is our trade balance, which, as you know, has been much worse than average. Three years into comparable business recoveries would find exports in real terms up by 25 percent; in the current expansion they are barely one percent above their end-of-recession levels. Imports, on the other hand, have risen 57 percent, while in past recoveries they were up an average of only 22 percent. This turnaround reflects the changed value of the dollar. At its peak earlier this year, the dollar was 27½ percent above its level at the end of the last recession compared with an average increase of barely two percent in the past.

One of the more confusing pictures is painted by the labor situation. Depending on one's point of view, it is possible to be either concerned or enthused when looking at the behavior of unemployment and employment during the current recovery compared with the past. For example, at 7.1 percent, the civilian unemployment rate is 2½ percentage points higher than its average at this point in past business recoveries. However, the decline in the unemployment rate since the end of the last recession, 3½ percentage points, is so far greater than the average of 2⅓ percentage points. Of course, it started out higher in this upswing.

Turning to employment, the number of people working has climbed by about nine percent so far in this expansion compared with an average rise of 7½ percent. However, not all sectors have shared in this gain. After keeping up with the postwar average for the first two years, factory payrolls have since declined to the point where they are only about seven percent greater than they were at the end of the last recession compared with a

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postwar average increase of nearly 11 percent. By contrast, employment in service industries has grown much faster than average, 16½ percent versus 12⅓ percent. Government employment, on the other hand, has grown much more slowly than average, four percent versus 10½ percent. Finally, the employment rate (civilian employment divided by the noninstitutional population over the age of 16) is now at a postwar peak of 60⅓ percent.

. . . Reveals Strength In Consumer Spending . . .

In view of this strong growth in employment, it would be reasonable to expect personal incomes growth to be strong as well. Unfortunately, this is not the case. By previous standards, the 22 percent rise in personal incomes so far in this recovery is weak, since the average gain is over 29 percent. This traces to several factors. Wage and salary disbursements are up less than average, reflecting a need on the part of many businesses to hold the lid on costs due to the inability to raise selling prices that has accompanied the reduced rate of inflation. Foreign competition has also played a role, as has the fact that much of the job gains has come in lower-paying service industries. Another reason for personal income's weakness is interest income. After rising much faster than average by the middle of 1984, interest income has since declined. Of course, it should be noted that the level of interest income is much higher today than in the past.

This slowdown in nominal income growth has more than offset the cut in personal taxes and the slowing of the rate of inflation that has occurred this time around. As a result, buying power (take-home pay adjusted for inflation) is up only 1⅓ percent, year-over-year, compared with an average gain of 4½ percent. In fact, the four-quarter increase in buying power today is almost as small as it was at the end of the last recession. In the face of this, people have increased their outlays at a faster rate this time than they did on average in the past. Personal consumption expenditures adjusted for inflation are up over 14 percent so far in the current expansion compared with an increase of little more than 12 percent. What's interesting here is that total consumption has been pushed upward faster than average by spending on goods as opposed to services.

If personal incomes are growing more slowly than average while personal consumption is rising faster than average, it has to show up in terms of use of credit and in the level of personal savings—and it does. Consumer credit outstanding is now 60 percent above its level at the beginning of this recovery compared with an average growth rate of 42¾ percent. As a share of take-home pay, consumer credit outstanding is currently at a record. Not surprising, the reported savings rate is far below average. Whereas the savings rate at this point in the typical postwar recovery was one percentage point above its level at the end of the past recession, today it is nearly three percentage points below.

Considering the damage that the strong dollar is supposed to have done to the goods-producing sector of the U.S. economy, it is interesting to note that growth in industrial production so far in this recovery, over 24 percent, is not far below other comparable recoveries whose average comes out to 27½ percent. However, back in the middle of 1984, growth in industrial production was nearly four percentage points greater in the current recovery than in the average of the previous ones.

gap compared with the past is true for both equipment as well as for structures. It seems to be a byproduct of several developments. First of all, the jumping off point was extremely low, since the drop in output of business equipment during the 1981-82 recession was not only nearly twice as great as average, it was the worst decline in the postwar era. Second, the Economic Recovery Tax Act of 1981 made it extremely lucrative for business to invest in new capital goods, once the recession ended and demand revived. But while producers of structures have benefited from the better than average increase in spending on factories, office buildings, warehouses, shopping centers and the like, manufacturers of business equipment have increasingly been left at the starting

COMPARING POSTWAR BUSINESS EXPANSIONS

	Duration in months	% Change in Real GNP	% Change in Real Domestic Demand	% Change in Real Exports	% Change in Real Imports	Lowest Jobless Rate	% Change in Real Personal Consumption	% Change in Real Business Fixed Investment	Point Change in Consumer Price Inflation	% Change in Dow Jones Industrial Average
Oct 1945 – Nov 1948	37	NA	NA	NA	NA	NA	NA	NA	NA	NA
Oct 1949 – Jul 1953*	45	27.2	28.2	19.5	46.1	2.5	12.7	31.0	3.0	45.0
May 1954 – Aug 1957	39	13.2	12.5	32.7	18.3	3.7	13.4	22.8	2.6	51.1
Apr 1958 – Apr 1960	24	10.2	10.1	15.1	14.1	4.8	9.5	15.3	1.6	38.7
Feb 1961 – Dec 1969*	106	47.2	49.0	71.2	125.4	3.4	46.2	80.1	4.5	21.4
Nov 1970 – Nov 1973	36	16.7	15.2	45.5	21.6	4.6	13.8	27.6	2.6	14.3
Mar 1975 – Jan 1980	58	24.3	23.4	58.1	59.2	5.6	22.9	42.3	3.6	12.5
Jul 1980 – Jul 1981	12	4.0	5.0	1.9	15.4	7.2	2.8	8.9	–2.5	4.2
Average—all expansions	45	20.4	20.5	34.9	42.9	4.5	17.3	32.6	1.7	26.7
Average—peacetime	34	13.7	13.2	30.7	25.7	5.2	12.5	23.4	0.9	24.2
Average 1st 36 months	36	16.2	14.3	24.6	21.5	4.7	12.4	20.4	1.3	28.3
Nov 1982-to-date	**36**	**14.2**	**18.7**	**1.0**	**56.7**	**7.0**	**14.4**	**35.1**	**1.3**	**31.5**

*wartime
NA: Not available

. . . And In Business Investment . . .

Not surprising, capacity utilization in the key manufacturing sector is far below average. Three years into the previous recoveries which lasted this long found capacity utilization averaging more than 85 percent. Today it is 80 percent—down from 82 percent in summer 1984. One reason for this decline can be seen in the efforts of manufacturers to trim their inventories. At this point in past recoveries the inventory-sales ratio in manufacturing averaged 1.64. Today, because of higher real rates of interest and more efficient computer-run controls, the ratio stands at only 1.47.

In the face of this, growth in business investment has been much greater than average. Real business fixed investment today is 35 percent higher than it was at the end of the last recession, whereas it stood 20½ percent higher in the five previous comparable recoveries. This gate because of the strong dollar. More than one-fifth of all business equipment purchases last year came from overseas; in 1970, only one dollar out of every 16 that was spent on business equipment went abroad.

The government is exhibiting diverse trends. On the one hand, government spending as a share of gross national product is higher today than in the past—to no one's great surprise. Meanwhile, government revenues are expanding much more slowly than they usually do at this point in a business recovery. At the Federal level, adjusted for inflation, the rise in government revenues so far is eight percent compared with over 22 percent in past expansions. Obviously, this reflects the combination of the tax cut of 1981 and the slowdown in the rate of inflation. Of course, the Federal government's budget deficit dwarfs its level at this point in previous recoveries, both nominally and in real terms.

. . . While Inflation Is Down Markedly

As has been observed previously, inflation looks much better today than it has in the past. The most recent 12-month change in the consumer price index, 3¼ percent, is far below the average for this point in a business recovery of 4½ percent. What is more, in past recoveries this rate was inching up whereas this time around, it has been moving down since the early part of 1984 following a brief increase. In fact, the 12-month rate of consumer price inflation today is 1⅓ percentage points less than it was at the end of the last recession whereas in the past it averaged 1⅓ points higher.

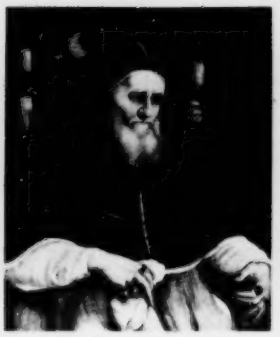
Notwithstanding the better than average showing for inflation, interest rates remain higher than average both in nominal and in real (adjusted for inflation) terms. The 3-month Treasury bill rate today averages about 7¼ percent compared with an average of 4½ percent in the previous recoveries. The real rate on T-bills today is nearly four percentage points compared with zero in the past. The same comparison is true when one looks at bond yields. At 11½ percent, AA utility bonds are about five percentage points above their postwar average. After subtracting inflation, the gap is even wider: 8½ percent versus 1½ percent.

Rather than focusing on the improvement in the inflation rate, the markets are apparently looking more at economic policy in determining the cost of short- and long-term money. The budget deficit is one part, the money supply is another. And so far in this expansion the money supply has grown much faster than it has in the past. The level of the money supply is 28 percent higher today than it was at the end of the last recession compared with growth of 14 percent in the past.

Perhaps the best way to sum up this comparison is to see what Wall Street thinks. The Dow Jones industrial average usually goes up during a business recovery and this time is no exception. In the beginning the Dow more or less tracked its past performance. However, early in 1984 stocks took a header, putting their cumulative growth by the middle of that year well below postwar averages. However, stocks soon got their second wind and are now up about 32 percent since the end of the last recession compared with a 28 percent average rise in the past.

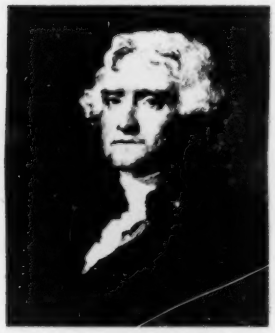
In my judgement, one should not write this recovery off just yet. It is stronger than it looks and is not as out of shape as some think. What is more, events that have already occurred, such as the drop in the value of the dollar, the decline in interest rates and the surge in money growth, along with the liquidation of inventories in many lines of business, suggest that 1986 may turn out to be a lot better than many now anticipate.

15th Century: Lorenzo de Medici and his family lead the cultural flowering of Florence.



1508: Pope Julius II commissions Michelangelo to paint the Sistine ceiling.

1717: George I is honored by the composition of Handel's *Water Music*.



18th Century: Thomas Jefferson becomes a noted patron of the arts.

1829: James Smithson of London bequeaths his fortune to the U.S. to establish a museum.

1892: Andrew Carnegie provides the funds to build Carnegie Hall.

Manufacturers Hanover is pleased to carry on the tradition of private sponsorship of the arts for the benefit of the public.

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DECEMBER 1985

Closing The Gap

It has come to my attention that our forecast of continued expansion in the U.S. economy with a better balance between the service sector and the goods-producing sector has been greeted with more than the usual amount of skepticism. This is because it hinges to a great extent on a decline in our trade deficit at least equal to the amount by which domestic demand is likely to slow, given the fact that we are now in the fourth year of the business expansion and spending usually takes a breather about this time.

To be sure, with the dollar down by nearly 25 percent against the currencies of our major trading partners, it is not unreasonable to expect a smaller trade deficit in 1986 compared with 1985. However, questions have arisen about which of our exports might be expected to rise to help close the trade gap, and which imports might fall. This is because the dollar has not declined uniformly against all currencies. Indeed, it has actually gone up against the currencies of a number of countries whose exports compete with ours abroad and/or whose industries sell primarily to our domestic markets (see Charts I and II). In addition, there seems to be

CHART I
U.S. DOLLAR DEPRECIATION VS. SELECTED CURRENCIES
(FEBRUARY 27, 1985 = 100)

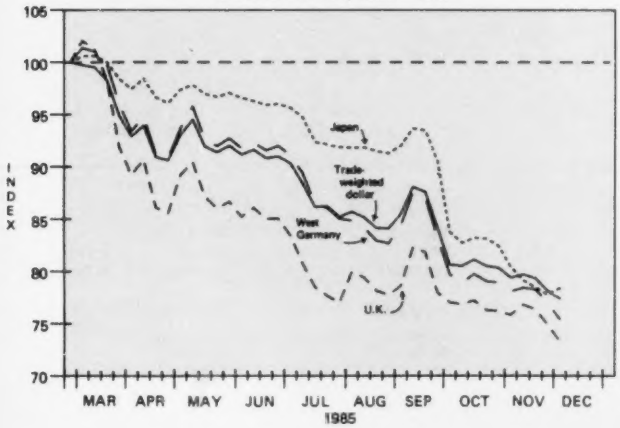
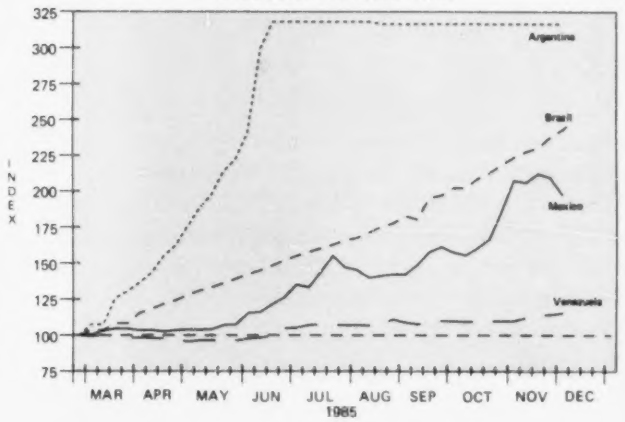


CHART II
U.S. DOLLAR APPRECIATION VS. SELECTED CURRENCIES
(FEBRUARY 27, 1985 = 100)



enough excess goods around, as well as the capacity to produce them, to tempt a number of countries to cut selling prices where their currencies have risen, in order to maintain market share.

Thus I thought it would be appropriate this month to dissect our merchandise exports and imports by country and by category to see whether our expectations of gradually declining imports and rising exports during 1986 are logical. Let us look at the import side first, since imports are roughly two-thirds greater in value than exports at the present time. As Table I indicates, our currency has dropped the most against those countries from which 44 percent of our imports originate. These items are machinery, transportation equipment, and chemicals and related products. What is more, these three categories together account for 34 percent of U.S. industrial production.

Lower Imports Are Likely ...

To be sure, there are some countries whose exports fall within these three categories whose currencies have declined against the dollar. However, for the most part, they are not major suppliers to the U.S. market. Thus, it seems sensible to expect that prices of machinery,

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transportation equipment, and chemicals and related products imports will soon rise, reflecting the decline in the value of the dollar. When they do, purchasers of these items will turn increasingly to U.S. sources. This would suggest a decline in imports and a corresponding fillip to domestic manufacturers.

As Table I also indicates, the dollar has appreciated against the currencies of all the major countries exporting to us two categories of goods: food and clothing. However, these items account for only about ten percent of our merchandise imports and about 13 percent of factory output. Obviously, one should not expect imports of these categories to slow—at least in response to currency changes—so those domestic industries which compete with these imports are likely to remain depressed unless demand picks up to a much greater extent than many now anticipate.

The dollar has also risen against the currencies of most of the world's oil producing countries. However, this is not likely to result in a surge of imports for several reasons. First, there is ongoing conservation. Ever since the first round of oil price increases in 1973-74, the U.S. has become progressively more efficient when it comes to energy use in general and petroleum products in particular. For 50 years prior to 1973, each one percent increase in the real gross national product required a one percent increase in energy input. In the dozen years since then, this ratio has been cut substantially.

A one percent increase in energy usage today can support up to a five percent rise in national output. Since the real GNP in 1985 most likely grew by only 2½ percent, and may not grow much more than 3½ percent in 1986, you can see where our usage of energy in general and petroleum in particular is declining and will probably continue to fall. Besides conservation, the umbrella created by the earlier increases in oil prices has encouraged the exploration and production of oil from both within the U.S. (the North Slope of Alaska) as well as from such areas as the United Kingdom—whose currency, the British pound, has risen against the dollar.

... While Exports Rise

Turning to exports, we find from Table II that the dollar has fallen substantially against the currencies of those countries competing with us in nearly 60 percent of the goods we sell abroad. These goods are in the machinery, transportation equipment, chemicals, and instruments categories. These same four categories account for nearly 37 percent of our industrial production. Thus, if these exporters pass along to their foreign customers the benefits of the decline of the dollar, they should soon experience a pickup in demand.

On the other hand, the dollar has either remained unchanged or has risen against the currencies of those countries which are major food exporters. In the case of Argentina, the rise has been quite substantial, as you can see. However, exports of food and live animals account for less than nine percent of U.S. exports and this category amounts to only eight percent of industrial production. Similarly, the rise in the dollar against the currencies of those countries which export refined petroleum products is somewhat mitigated by the fact that these exports account for only 4½ percent of total U.S. exports.

On the question of excess capacity, it may be true that both developed and developing countries are producing more goods than consumers are willing to buy—at least for the time being. Some observers have termed this a "glut economy," wherein overabundance has replaced the chronic shortages of a few years ago. The net result

TABLE I

TOP SIX CATEGORIES OF U.S. IMPORTS:

Major Source Countries and U.S. Dollar Depreciation or Appreciation since late February peak

Machinery [16.7%*]		Transportation Equipment [9.1%*]		Mineral Fuels, Lubricants & Related Materials [11.1%]		Food & Live Animals [8.0%*]		Clothing & Accessories [5.1%*]		Chemicals & Related Products [8.1%*]	
Share of U.S. Imports 21.7%		Share of U.S. Imports 17.5%		Share of U.S. Imports 15.3%		Share of U.S. Imports 5.6%		Share of U.S. Imports 4.6%		Share of U.S. Imports 4.3%	
Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)
U.K.	−26.7%	Germany	−25.5%	U.K.	−26.7%	Canada	+ 0.5%	Hong Kong	+0.1%	U.K.	−26.7%
Germany	−25.5	Japan	−22.3	Algeria	− 8.5	Taiwan	+ 1.4	Taiwan	+1.4	France	−25.7
Japan	−22.3	Canada	+ 0.5	Canada	+ 0.5	Philippines	+ 2.9	Korea	+5.5	Germany	−25.5
Singapore	− 6.3			Saudi Arabia	+ 1.4	Australia	+ 3.7			Japan	−22.3
Canada	+ 0.5			Indonesia	+ 2.7	Mexico	+ 97.0			Canada	+ 0.5
Taiwan	+ 1.4			Venezuela	+15.3	Brazil	+142.6				
Mexico	+97.0			Mexico	+97.0						

*Share of U.S. Industrial Production

Sources: Commerce Department, Federal Reserve Board, MH.

is falling prices, compared with the upward spiral that characterized the late 1970s.

However, just as the soaring prices of the 1970s ultimately carried the seeds of today's deflation, the same may be said for the current round of declining prices. The inflation of the 1970s, by raising the returns available on a wide variety of enterprises ranging from mining to farming to manufacturing, encouraged people either to enter these fields or to expand if they were already in them. Ultimately this resulted in a tremendous growth of capacity, which, in turn, created the conditions that exist today. It stands to reason, therefore, that falling prices will force people either to exit from these endeavors, or to contract their activities until only those who are profitable survive. This will ultimately shrink excess capacity and cause prices to firm once again.

Excess Capacity Should Shrink

At the moment, however, because of some countries' external debt problems, the ongoing softness in basic commodities' prices is causing an increase in production. This is because these countries must maintain—if not increase—their export revenues in order to service their external debts. Clearly the more they produce the lower prices will go, leading to even further production. This downward spiral can only be broken by an increase in demand, and such an increase seems to be on the horizon. For one thing, most of these commodities are denominated in dollars. Thus, the lower-valued dollar will boost the buying power of other countries and should lead to an increase in their purchases. Also, growth in the other major industrial economies must pick up soon, if the efforts of the Fed and the other major central banks to keep the dollar down are to remain successful.

I hope I have convinced you that our expectations of a shrinking trade deficit adding strength to the U.S. economy in 1986 are not extreme. Obviously, the gap between imports and exports will not go away anytime soon. Indeed, it may hold steady or even widen a bit in the near term. This is because of the distinct possibility that there may not be a change in prices of merchandise imported from those countries whose currencies have risen against the dollar. Some foreign exporters may wish to accept smaller profit margins, rather than lose share of market to U.S. producers. In view of the fact that many of them never lowered their prices to reflect their currencies' progressive weakness against the dollar between mid-1980 and early 1985, they would appear to have a substantial cushion with which they could absorb any decline in profit margins.

If foreign exporters do raise selling prices in the U.S., it would cut into the purchasing power of our citizens, thus causing them to spend less. Not only would the increase in prices of imported goods affect people's ability to buy them, but they might well be matched by price increases by domestic manufacturers, seeking to take advantage of the umbrella provided to restore their profits. Given recent experience with price inflation, however, I would not expect this to be much of a factor, this time around. People in all walks of life and business seem to be very resistant to price and cost increases.

Thus, I do believe that the trade picture will add to the economy in 1986 rather than subtract as it did in 1985. Remember, to stop subtracting from domestic output, all that is necessary is for our trade deficit not to widen any further. I think this is a reasonable expectation in view of the foregoing discussion. And to the extent that the trade gap actually shrinks a bit, it becomes a definite plus to our gross national product. H

TABLE II

TOP SIX CATEGORIES OF U.S. EXPORTS:

Major Competitor Countries and U.S. Dollar Depreciation or Appreciation since late February peak

Machinery [16.7%*]		Transportation Equipment [9.1%*]		Chemicals & Related Products [8.1%*]		Food & Live Animals [8.0%*]		Mineral Fuels, Lubricants Related Materials [11.1%*]		Professional, Scientific & Controlling Instruments & Apparatus [2.7%*]	
Share of U.S. Exports 28.2%		Share of U.S. Exports 16.3%		Share of U.S. Exports 10.4%		Share of U.S. Exports 8.9%		Share of U.S. Exports 4.5%		Share of U.S. Exports 3.1%	
Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)
U.K.	−26.7%	U.K.	−26.7%	U.K.	−26.7%	Canada	+ 0.5%	Algeria	− 8.5%	U.K.	−26.0%
France	−25.7	France	−25.7	France	−25.7	Australia	+ 3.7	Canada	+ 0.5	Germany	−25.5
Germany	−25.5	Germany	−25.5	Germany	−25.5	Argentina	+216.6	Australia	+ 3.7	Japan	−22.3
Japan	−22.3	Japan	−22.3	Japan	−22.3			Poland	+ 8.0	Canada	+ 0.5
		Canada	+ 0.5	Canada	+ 0.5			Venezuela	+15.3	Mexico	+97.0
								Colombia	+41.0		
								South Africa	+41.3		
								Mexico	+97.0		

*Share of U.S. Industrial Production
Sources: Commerce Department, Federal Reserve Board, MH.

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Curves

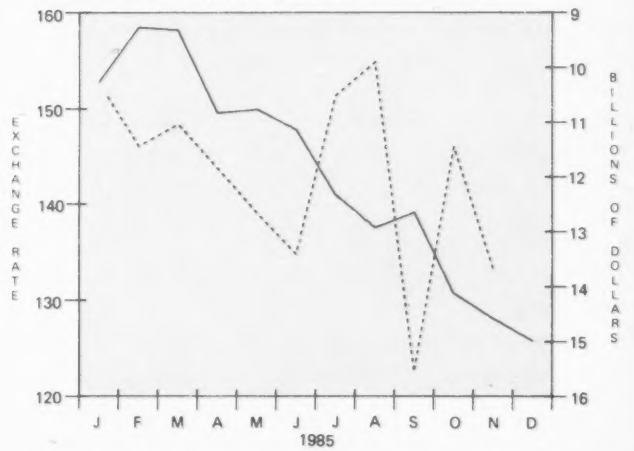
Economists are fond of using curves to describe the behavior of consumers, businessmen, and markets. Leafing through several of my textbooks the other day, I came up with a variety of curves. There are yield curves, demand curves (regular and kinked), supply curves (regular and backward bending), indifference curves, cost curves (average and marginal, short- and long-run), product curves, revenue curves and market equilibrium curves, just to name a few. These curves are probably arcane to most noneconomists, however important they may be. But there are three curves that have made their way into the common lexicon because they have become useful tools for policymakers. Indeed, these curves are so much a part of our economy today that they warrant a discussion at this time.

The J Curve

No doubt the curve that everyone is keeping a close watch on today is the J curve. This is because it deals with the reaction of our balance of trade to a change in the value of the dollar in foreign exchange markets. As readers know by now, because of the sharp climb in the value of the dollar between July 1980 and late February 1985, our merchandise trade balance was driven into the red by an unprecedented amount. After running a surplus throughout most of the 1960s, our merchandise trade balance slipped into deficit in the early 1970s, but even as recently as early 1983 was not more than $10 billion in the red on a quarterly basis. Since then, however, it has been all downhill, with the latest reading showing a quarterly deficit in excess of $33 billion, or an annual rate of $132 billion.

Now that the dollar is down by nearly 25 percent against the currencies of our major trading partners compared with late February 1985, a number of observers have come to believe that the trade deficit will narrow this year compared with last (Economic Report—December 1985). Indeed, such a narrowing—

CHART I
U.S. DOLLAR TRADE WEIGHTED EXCHANGE RATE <MAR. 1973=100> (LINE) VS. MERCHANDISE TRADE DEFICIT, INVERTED SCALE (DOT)



or, at the very least, no further widening—of the trade deficit is critical to those forecasts which project better growth this year than in 1985. This is because the trade deficit, as it widened, subtracted a considerable amount from economic growth.

It is reasonable to expect the trade deficit to shrink now that the dollar is down. This is because foreign-made goods will be marked up in price, reflecting the rise in foreign currencies compared with the U.S. dollar. At the same time, goods produced in the U.S. intended for sale abroad will become more competitive if exporters follow the dollar down and adjust their prices in foreign currencies accordingly. Notwithstanding this logic, the first reaction of our trade deficit to the decline in the value of the dollar was a widening rather than a shrinking (Chart I). This is what is known as the J curve effect. It stems from the fact that, in the wake of a decline in the value of the dollar, imports go up in price faster than the demand for imported goods falls. This becomes the downward slope of the J. After a while, higher import prices will depress import demand, causing a slowing in the dollar value of imports.

The same is true for exports. They do not rise immediately following a drop in the value of the dollar.

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This is due to the fact that much of our exports are covered under contracts which may have already fixed prices and quantities. In addition, as the December Economic Report observed, much of our exports are in big-ticket capital goods which take many months to move from orders to deliveries. Once deliveries are made and new contracts are negotiated, they will reflect the lower dollar price and exports will begin to rise. As exports rise and imports fall, our trade balance will trace the upward slope of the J and will narrow.

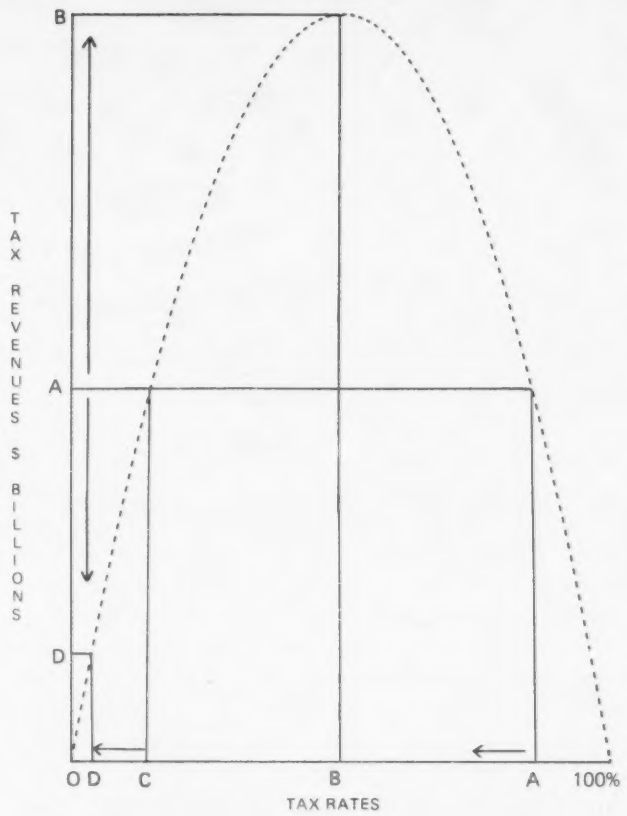
The Laffer Curve

Just as the J curve is very much in the spotlight today, so the Laffer curve was center stage a few years ago. It takes its name from the economist Arthur B. Laffer, who is said to have first drawn the curve on a napkin in a Washington D.C. restaurant in 1974. He was trying to illustrate the proposition that there are always two tax rates that yield precisely the same revenues. As you can see from Chart II, those tax rates are zero and 100 percent. When taxes are 100 percent, the government collects no tax revenues because people will not work in a money economy if all the fruits of their labor are confiscated by the government. At the other extreme, it is also clear that if the tax rate is zero and people keep 100 percent of the revenues they receive for their production, the government's take is also zero.

So far, this is logical and easy to understand. Equally comprehensible is the next step in this analysis, which is that any government tax rate greater than zero and less than 100 percent will yield some revenues. This can also be seen from Chart II. You will notice that, the way the curve is drawn, it is possible to obtain roughly the same revenues from two different tax rates. The first (A) represents a high tax rate and low production, while the second (C) represents a low tax rate and high production. Obviously, by moving further away from 100 percent tax rates on the right side and zero tax rates on the left side, the government will approach a point at which revenues are maximized. This point can be seen on the chart as point B. Any movement past point B, whether it is lowering or raising the tax rate, will reduce revenues.

The question then becomes what tax rate corresponds with point B. Point B is not 50 percent as might be implied from the symmetrical nature of the curve, although it can be. Followers of the Laffer curve would prefer to observe that point B is a variable number, the point at which the electorate desires to be taxed. Laffer's analysis suggested that our tax rates are so high that we are on the descending portion of the curve thereby producing less than maximum tax revenues to the government. He thought that cutting tax rates, say

CHART II
LAFFER CURVE



from A to B, would cause revenues to rise toward their maximum level. It is this curve that formed the basis for the tax cuts enacted by the Reagan Administration in 1981.

Notwithstanding the geometry as well as the economic logic behind it, the facts are that this plan did not work. Rather than raising revenues to help erase Washington's budget deficit, the tax cut slashed revenues and produced the 12-digit deficits that have been a hallmark of our economy for the past few years. Economist Laffer and his followers claim that other factors prevented his curve from working, such as the fact that the tax cuts were spread out over several years, the tight money implemented by the Federal Reserve, the lack of a gold standard, and so forth. However, most economists dismiss these arguments and concentrate instead on what they consider to be a more fundamental flaw in this kind of analysis. It is their belief that current tax rates are well to the left of the maximum point, say C, rather than to the right, at A, and, as you can see from the chart, cutting them to, for example, D, permanently lowers the revenue base rather than increases it. This would seem to be a reasonable argument. For one thing, tax rates average only about 24 percent. For another, 4½ years have gone by since taxes were cut and there is no sign that revenues are

rising any faster than they ordinarily would at this stage of a business recovery. And since they are climbing from a lower base while spending levels have been maintained, the deficit has remained huge.

The Phillips Curve

So far the score is tied. We have seen that one curve, the J curve, appears to be working as usual, while the other, the Laffer curve, is not. Now we come to the third curve, the Phillips curve, whose success appears to be a combination of the two previous curves. That is—the Phillips curve used to work, did not seem to for a while, and now appears to be operative once again.

Although the Phillips curve is used today to describe the seemingly inverse relationship between unemployment and inflation, in its original form, it dealt with changes in the wage rate and the unemployment rate. A.W. Phillips, in a study published nearly 30 years ago, found that there was a stable nonlinear inverse relationship between changes in the wage rate and the unemployment rate in the United Kingdom. What is more, he found that this relationship seemed to apply for a period of almost 100 years (1861 to 1957).

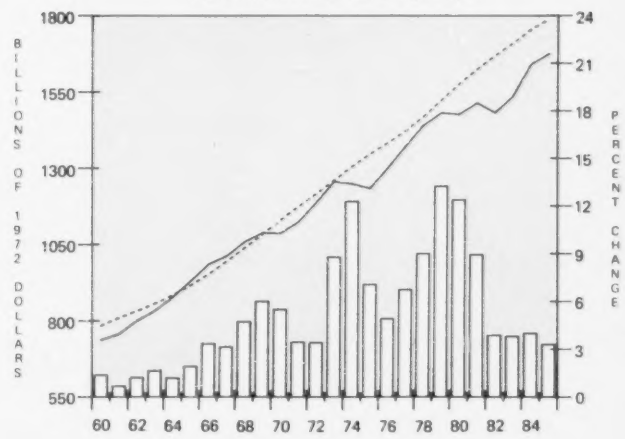
In plain English, Phillips observed that in periods when unemployment was low, the percentage increase in money wages tended to be high. By contrast, when unemployment was high, the percentage increase in money wages tended to be low. This makes sense, since labor's bargaining position is directly affected by how many of its members are working and how many are not. When there are few people out of work, labor is in a better position to demand higher money wages than when a lot are jobless.

Since this study was published, other economists conducted similar studies using U.S. data. What is more, by assuming constant markup pricing on unit labor costs, these economists were able to transform the Phillips curve into a tradeoff between price (rather than wage) inflation and unemployment rates. They did this because both inflation and unemployment are matters of public policy and it was thought that if a tradeoff existed between unemployment and inflation, policymakers could pick some acceptable combination of the two. Indeed, this was the basis for the economic philosophies of the two major political parties in the United States. The Democrats tended to be more concerned about unemployment than inflation while the Republicans seemed to be more worried about inflation than unemployment.

However, just as sides were being chosen, the tradeoff stopped working. What appeared to be a pretty good inverse relationship between unemployment and inflation from the mid 1950s to the late 1960s, seemed to fall apart in the 1970s, in the wake of such major developments as sharply rising oil prices, a change in the composition of the labor force toward greater participation by women and teenagers, more aggressive union behavior, and greater disincentives to work as a result of government income maintenance programs. Supporters of the Phillips curve argued that the tradeoff still existed, only it worsened—in other words the curve shifted to the right. Others pointed out that what is true for short-run periods in the U.S. is not necessarily true for the longer run.

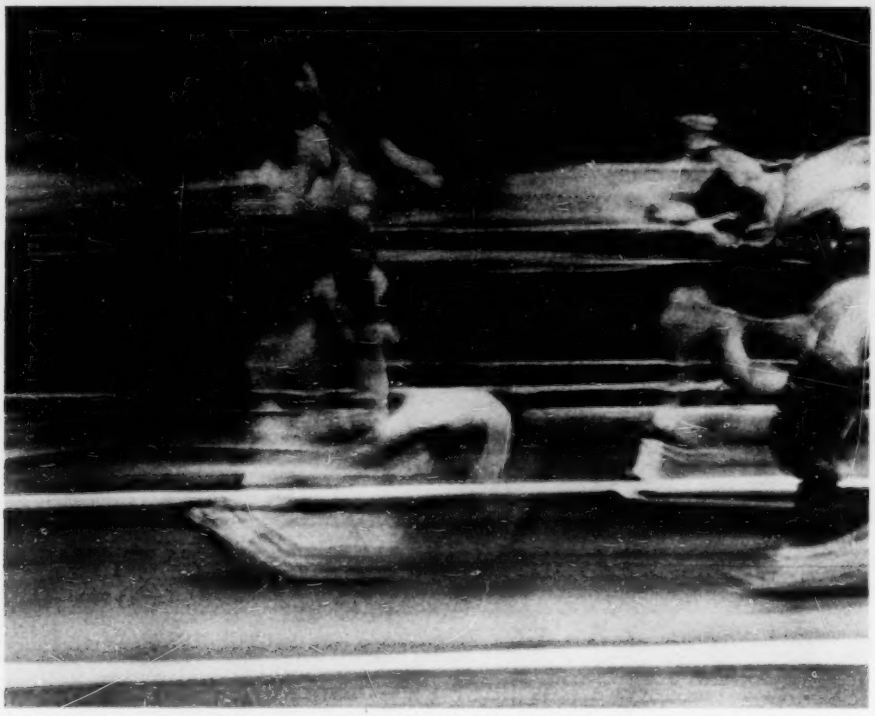
If you look at Chart III, you will see that inflation does seem to respond to utilization pressures within the economy. Instead of the unemployment rate, I prefer to use the gap between actual and potential real GNP. Looking at the Phillips curve this way, you can see that inflation does worsen when the economy is at or above potential and inflation does subside when a gap opens up in the form of unused resources.

CHART III
ACTUAL REAL GNP (LINE) VS. POTENTIAL REAL GNP (DOT) VS. 12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX (BAR)



Therefore, it would seem that, if one uses as a proxy for the unemployment rate the gap between actual real GNP and potential real GNP, one can see that price pressures do respond to the degree of slack in economic activity. Near-full utilization of resources helped drive the inflation rate up in the late 1970s. This was brought down by two back-to-back recessions, which resulted in considerable unused resources. Obviously, it should not be inferred from this that it is possible to base policy decisions on the Phillips curve. However, policymakers should understand that the rules of economics still work pretty much the way they used to: To bring down high inflation, one must create economic slack and if the economy approaches full utilization of resources, the chances are inflation will worsen.

H



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

FEBRUARY 1986

Business Conditions Update

The economic and financial outlook for 1986 remains bright. Notwithstanding continued pessimism in some quarters, it still appears as though the gross national product adjusted for inflation will rise by a faster clip this year compared with 1985. Both inflation and interest rates will remain moderate while the unemployment rate should trend lower.

A look beneath the surface indicates that this is even better news than it seems. For one thing, the expansion will be better balanced than it was last year. The goods-producing sector should make more of a contribution to economic growth this year than last, when services provided most of the thrust. For another, we are now in the 39th month of the current business expansion, and typical postwar peacetime expansions have lasted only 34 months. Indeed, once we enter the 40th month in March, the ongoing expansion will become the second-longest post-World War II peacetime expansion. Only the 58-month expansion of March 1975 to January 1980 was longer. Not a bad performance for an upswing that has been termed weaker than normal and which some economists even wrote off completely a year ago.

The Signs Are Positive...

The momentum that the economy developed toward yearend 1985 will help it throughout 1986. Not only is the jumping-off point higher than the average of last year's fourth quarter thereby ensuring a good growth rate in the current quarter, but the momentum seems strong enough to carry growth throughout the year—and at an increasing pace. Lest you think that these statements are bold with no backup, let me cite a number of facts upon which our forecast is based:

- The foreign exchange value of the dollar has fallen by about 27 percent in the past year;
- Growth in the money supply in 1985 was the fastest for any year in postwar history;
- The rate of business inventory building slowed at the sharpest pace for any 12-month period since the end of the second World War;
- Employment is at a record level—both in terms of the number of people at work, as well as when compared with the over-sixteen population;
- The stock market has jumped more than 30 percent in the past five months, setting new records in the process;
- Oil prices in spot markets have fallen by as much as 50 percent since last autumn.

Now what I would like to do is draw some implications from each of these facts that bear on the business outlook. The 27 percent drop in the value of the dollar compared with the currencies of our major trading partners bodes well for domestic producers of goods. It is true that there is a lag between when the dollar peaks and when the trade deficit begins to fall (Economic Report—January 1986). However, one year has now gone by since the dollar peaked, which is on the long end of previous lags. Furthermore, evidence from the "real" economy seems to suggest that an adjustment is already being made. Employment in manufacturing industries has been climbing for four consecutive months, reversing some 60 percent of the decline in factory jobs that occurred between January and September 1985. Manufacturing output is up by 1½ percent since October after changing very little in the previous 12 months.

The implications of rapid money growth are less ambiguous and faster-acting. First of all, there is plenty of money available for spending. In addition, funds can be borrowed at interest rates well below those of a year ago. For example, the rates that banks charge their biggest and best customers for short term loans are approximately one percentage point lower today than they were last year at this time. Those corporations that are big enough and have a high enough credit rating to access the money markets directly are also finding interest rates about one percentage point below last year. And this is for short-term borrowing; funds raised in the bond markets cost business nearly three percentage points less today that they did in early 1985.

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Credit the Federal Reserve for these developments. Ignoring its rigid money supply targets, the Fed has been extremely accommodative over the past several years, making sure that the supply of money and credit available in the economy has exceeded the demand so that interest rates might fall. There is every reason to think that the Fed will continue this posture. For one thing, although economic growth is picking up this year compared with last, it is far from a pace that would be considered so rapid as to lead to an overheated economy. There still remains a large amount of excess capacity in the United States, not to mention a large number of people without work who would like to be employed. In addition, there are sizable amounts of debt on the balance sheets of consumers, corporations and countries and the ability of these entities to service these debts would not be enhanced were interest rates to rise. Finally, and notwithstanding the rapid growth in the money supply, the rate of inflation remains moderate. Whatever linkage might have existed between money growth and inflation seems to have been loosened—if not severed completely—in the wake of the strong dollar and falling commodities' prices.

...For Faster Economic Growth...

The volatility in inventory spending and its effects on output can be seen in the economic growth rates posted over the past two years. Although the inflation-adjusted GNP grew only 2.3 percent in 1985, substantially below the 6.6 percent rate of advance of 1984, when changes in business inventories are subtracted from both years, the rate of growth did not differ materially. Real final sales increased by four percent last year, compared with 4½ percent in 1984.

The diversions in output in these years stemmed primarily from different postures toward inventory accumulation adopted by business. Early in 1984, there was a feeling in the business community that inventories had gotten too low relative to current and projected sales. In addition, many businesses believed that the rate of inflation would accelerate as it typically does in the second year of a business recovery. That belief provided an incentive to stock up on goods, since inflation would be increasing the value of inventories, thus boosting profitability. Futhermore, business plans for investment in plant and equipment were also strong, sending a signal to a wide variety of industries to gear up for the expected increase in demands. As a result, inventory accumulation of almost $63 billion (real terms) took place in 1984, adding more than two percentage points to that year's real GNP growth.

Last year the situation was reversed. The continued climb in the value of the dollar diverted increasing chunks of spending from domestically-made goods to foreign merchandise. Accordingly, sales fell short of expectations and businesses throughout the entire chain of production and distribution found themselves stuck with large amounts of unsold goods. When combined with the continued low rate of inflation posted both in 1984 and in 1985, along with high real interest rates, the air was taken out of the inventory balloon. Businesses turned cautious, determined to keep their stocks as lean as possible. While this led to more efficient inventory management in 1985, it did subtract almost two percentage points from GNP growth as the $63 billion accumulation pace of 1984 melted into an increase of only $5.6 billion in 1985.

As a result of these policies, inventories in many lines of business are now at extremely low levels relative to sales. It would thus seem logical to expect no further drain in output from inventory policies. This would be the case if inventories were accumulated no faster than sales are rising. But with demand now strengthening for domestically-produced goods, it is possible that business would want to step up the pace of inventory accumulation in order to serve customers better.

The rise in employment is nothing to be trifled with. In the past three years, civilian employment has jumped by nearly ten million people or ten percent, following three years of stagnation. Not only has this brought the unemployment rate down from a postwar peak of nearly 11 percent to 6.7 percent, the lowest rate in almost six years, but it has carried employment to record highs. This alone is significant, for it has put more dollars in the hands of consumers, whose spending accounts for two out of three dollars that make up the GNP.

High employment levels not only lead to greater spending because of increased incomes, they also encourage people to loosen their wallets because of greater confidence. Another impact on wealth and confidence can be seen from the stock market. While fewer than one person in five owns stocks directly, a great number are no doubt aware of developments down on Wall Street. So besides the greater spending power that a rising stock market confers on those who own stocks, there is greater confidence that develops among the population at large just from observing the stock market rise.

February, 1986
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

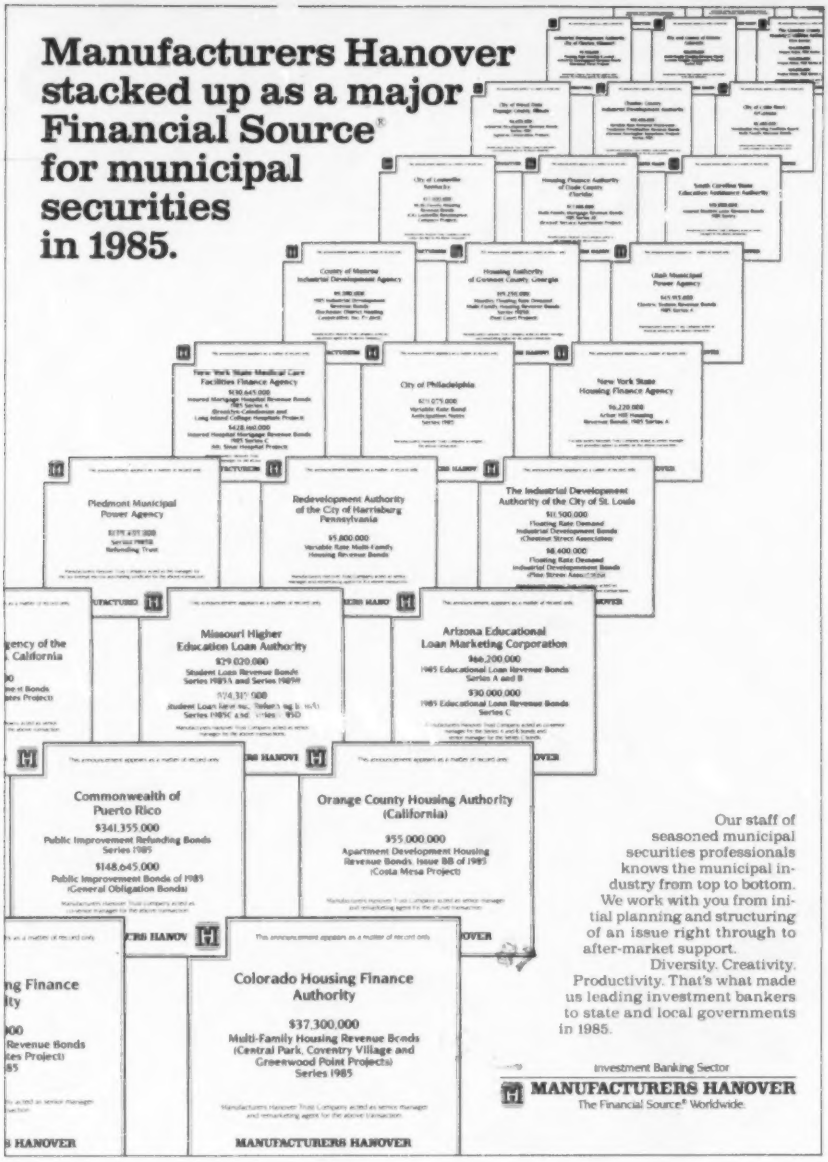
	< Actual						Projected >					
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3917.5	3960.6	4016.9	4061.5	3989.1	5.7	4144.9	4204.2	4278.1	4357.7	4246.2	6.4
GNP: $82	3547.8	3557.4	3584.1	3594.8	3571.0	2.3	3632.2	3660.4	3696.9	3735.8	3681.3	3.1
% Change, Annual Rates	3.7	1.1	3.0	1.2	2.3		4.2	3.1	4.0	4.3	3.1	
Consumption	2525.0	2563.3	2606.1	2634.0	2582.1	6.6	2683.0	2716.7	2760.7	2811.8	2743.1	6.2
Durables	351.5	356.5	376.0	360.3	361.1	9.1	371.7	375.4	382.9	392.6	380.6	5.4
Non-Durables	895.7	910.2	914.5	928.6	912.3	4.6	938.4	943.3	952.5	965.1	949.8	4.1
Services	1277.8	1296.6	1315.6	1345.1	1308.8	7.3	1373.0	1397.9	1425.4	1454.1	1412.6	7.9
Investment	657.6	672.8	666.1	678.0	668.6	−0.8	716.3	745.3	762.1	781.3	751.2	12.4
Non-Residential	459.6	474.2	478.5	490.9	475.8	11.2	499.4	507.2	515.5	520.8	510.7	7.3
Producers Durable Equipment	293.5	304.5	308.1	315.7	305.5	9.0	322.3	327.6	331.6	336.4	329.5	7.9
Structures	166.1	169.7	170.4	175.2	170.3	15.4	177.1	179.5	183.9	184.5	181.3	6.5
Residential	179.4	183.1	187.4	192.6	185.6	3.6	196.3	202.6	210.5	215.1	206.1	11.0
Inventory Changes	18.5	15.5	0.2	−5.5	7.2		20.6	35.5	36.1	45.3	34.4	
Net Exports	−42.3	−70.3	−87.8	−106.9	−76.8		−97.2	−95.6	−93.8	−92.5	−94.8	
Government Purchases	777.2	794.8	832.5	856.5	815.3	10.6	842.8	837.9	849.1	857.0	846.7	3.9
Federal Defense	249.5	256.0	269.9	272.5	262.0	10.6	267.4	263.0	267.4	270.3	267.0	1.9
Federal Civilian	84.9	81.7	95.0	110.4	93.0	22.4	92.1	84.2	84.1	79.1	84.9	−8.7
State & Local	442.8	457.1	467.7	473.6	460.3	8.6	483.3	490.7	497.7	507.6	494.8	7.5
Final Sales: $82	3532.0	3542.3	3585.8	3601.5	3565.4	4.0	3613.9	3629.3	3665.2	3696.3	3651.2	2.4
% Change, Annual Rates	6.2	1.2	5.0	1.8	4.0		1.4	1.7	4.0	3.4	2.4	
Domestic Demand: $82	3619.6	3658.5	3703.9	3728.8	3677.7	2.8	3763.7	3786.3	3816.5	3848.9	3803.9	3.4
% Change, Annual Rates	0.4	4.4	5.1	2.7	2.8		3.8	2.4	3.2	3.4	3.4	
GNP Price Index (1982 = 100)	110.4	111.3	112.1	113.0	111.7	3.3	114.1	114.9	115.7	116.6	115.3	3.3
% Change, Annual Rates	3.0	3.3	2.9	3.3	3.3		4.0	2.6	3.0	3.2	3.3	
Consumer Price Index (1967 = 100)	317.8	321.1	323.0	326.3	322.1	3.5	328.7	330.8	333.7	336.7	332.5	3.2
% Change, Annual Rates	3.3	4.2	2.4	4.1	3.5		3.1	2.6	3.5	3.7	3.2	
Total Personal Income	3240.9	3280.1	3298.5	3354.1	3293.4	5.8	3415.7	3464.8	3523.5	3582.6	3496.7	6.2
Disposable Personal Income	2739.2	2817.7	2800.2	2845.6	2800.7	4.9	2898.2	2937.7	2985.0	3031.9	2963.2	5.8
Savings Rate	4.8	5.9	3.7	4.1	4.6		4.0	4.0	4.0	3.7	3.9	
Unemployment Rate	7.3	7.3	7.2	7.0	7.2		6.8	6.7	6.6	6.4	6.6	
Indus. Production (1977 = 100)	123.8	124.2	124.8	125.2	124.5	2.2	127.7	128.3	130.1	132.5	129.7	4.1
Housing Starts (000)	1795.0	1771.7	1673.0	1747.3	1734.8	−1.6	1770.9	1887.0	1952.0	1908.4	1879.6	8.3
Domestic Auto Sales (000)	8454.7	8239.0	9440.3	6996.3	8282.6	4.2	7959.9	7480.8	7752.3	7842.3	7758.8	−6.3
Corporate Pre-Tax Profits	220.0	218.7	228.6	232.7	225.0	−5.3	233.6	246.7	256.0	263.0	249.8	11.0
− Taxes	83.4	82.3	87.4	89.3	85.6		89.5	96.1	99.6	101.9	96.8	
Net Profits	136.6	136.4	141.1	143.4	139.4	−3.2	144.1	150.6	156.4	161.1	153.1	9.8
− Dividend Payments	82.0	83.1	83.9	85.0	83.5	6.9	86.2	87.5	88.8	90.1	88.1	5.5
Undistributed Profits	54.6	53.3	57.3	58.4	55.9	−15.2	58.1	62.6	67.2	69.7	64.4	15.2
+ Depreciation	325.4	334.0	346.8	357.8	341.0		362.5	367.2	371.9	375.9	369.4	
− Inventory Profits	−0.7	−2.2	−4.7	10.0	0.6		−0.7	−4.0	3.6	13.1	3.0	
Net Cash Flow	380.7	389.5	408.8	406.2	396.3	10.7	421.3	433.8	435.5	432.5	430.8	8.7

...With Low Inflation

Notwithstanding the knee-jerk reaction of some in the media and on Wall Street, the recent drop in oil prices contains far more pluses than minuses. It may be true that some oil-exporting countries will receive less revenues than they did before. But they—and the non-oil developing countries that have been so much in the news of late—will also benefit from the reduced rate of inflation, lower interest rates, and faster economic growth in the industrial countries that will also result.

Oil's influence is so ubiquitous, its lower price is bound to be a tonic for our economy. For one thing, the drop in oil prices is analogous to a tax cut. It puts more purchasing power in the hands of consumers and business—yet it does not carry with it the adverse effects of lowering government revenues, thus widening the budget deficit. Speaking of deficits, if current prices hold, our trade deficit will be reduced by some $13 billion this year, since we import around 1⅓ billion barrels of oil annually. The cost of transportation both on the ground and in the air will decline, which means less inflation and/or greater profits. Since oil is widely used to produce power, the cost of manufacturing will decline—not to mention the cost of lighting and heating. Finally, because oil is also used as a feedstock—a component in the production process of plastics, chemicals, rubber and clothing—its decline in prices has obvious benefits here as well.

Putting it all together, we come up with a fairly bright forecast for the U.S. economy and its major sectors for 1986 [see table]. Not only will growth outpace last year's rate, but it will do so in the context of little or no change in the rate of inflation and relatively stable interest rates. When it comes to economic forecasting, there can be no guarantees. Unlike the "hard" sciences such as physics, chemistry and biology, economics is a "soft" science, dealing with the behavior of people, which is constantly changing. However, the existence of these facts makes the outlook about as definite as it could be, so relax and enjoy it.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$8,400,000
Floating Rate Demand Industrial Development Bonds (Pine Street Associates)
Missouri Higher Education Loan Authority
$29,020,000
Student Loan Revenue Bonds Series 1985A and Series 1985F
Arizona Educational Loan Marketing Corporation
$66,200,000
1985 Educational Loan Revenue Bonds Series A and B
$30,000,000
1985 Educational Loan Revenue Bonds Series C
Commonwealth of Puerto Rico
$341,355,000
Public Improvement Refunding Bonds Series 1985
$148,645,000
Public Improvement Bonds of 1985 (General Obligation Bonds)
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Colorado Housing Finance Authority
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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

MARCH 1986

Economic Policy Questions

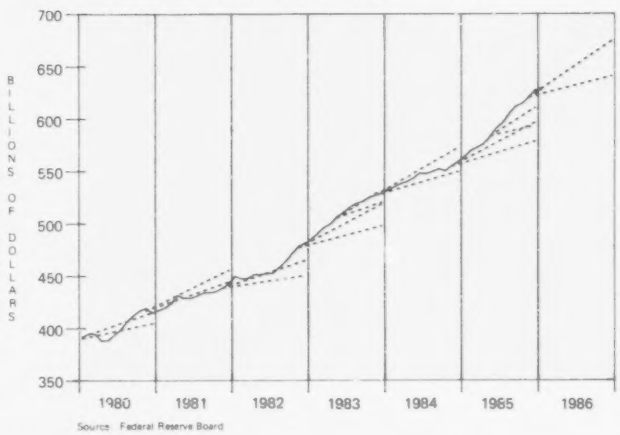
At present, policymakers are grappling with a number of economic issues. How these are resolved will have a significant bearing—not only on the outlook for the near-term, but, conceivably, for several years to come. At the top of the list is monetary policy and the extent to which the Federal Reserve, which just recently cut its discount rate, should ease even further. Right behind it is the question of the Federal government's budget, and how much red ink it will run—not just in the current fiscal year, but over the balance of this decade. It goes without saying that these two policy questions are very much intertwined, with each affecting the other to a considerable degree.

Monetary Policy: To Ease Or Not To Ease

When the Fed cut its discount rate on March 7th from 7½ percent to seven percent, it was responding to a variety of developments, some arguing for ease and some arguing against it. Looking back, it would appear that the events that led directly to the Fed's decision were similar moves on the part of Japan and West Germany. The Bundesbank cut its discount rate to 3½ percent from four percent, a development that was followed in short order by a cut in the Bank of Japan's discount rate from 4½ percent to four percent.

These central banks, and the others that followed, doubtless responded to signals—both overt and covert—that Federal Reserve Chairman Paul A. Volcker had sent during the previous few weeks. For example, in his testimony before the House Committee on Banking, Finance and Urban Affairs in February, Mr. Volcker pointed out that economic conditions abroad were not all that strong. While he did acknowledge signs of somewhat stronger growth in Germany than elsewhere in continental Europe, he did question "whether that growth will in fact be strong enough to reduce appreciably continued high levels of unemployment, now averaging more than ten percent for the continent as a whole." He also noted that in Japan, where unemployment is historically at much lower levels, "growth by these same historical standards is sluggish, with the appreciation of the yen itself a restraining factor."

CHART I
MONEY SUPPLY – M1 (LINE) VS. FEDERAL RESERVE'S GROWTH TARGETS (DOT)



Source: Federal Reserve Board

By cutting their key interest rates, these countries took an important step toward enhancing their own growth prospects. This is good in and of itself, to be sure. However, it will also help us to reduce our trade deficit by strengthening foreign markets for our goods. In spite of the roughly 30 percent drop in the value of the U.S. dollar in foreign exchange markets since February 1985, our trade deficit has not yet begun to shrink. It will soon, and when it does it will be a plus for domestic producers of goods, although the accompanying reduced inflow of funds to the U.S. might lead to renewed interest rate pressures in our financial markets, because of Washington's huge budget deficits and its accompanying sizable borrowing needs.

The decision to cut the discount rate, thus signaling to the markets that the Fed has eased a touch, was not easy to come by—cuts in foreign discount rates, notwithstanding. This is because of the many uncer-

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tainties that continue to characterize the economic scene. The labor force figures, themselves, typify these uncertainties. Although nonfarm payrolls in February rose 226,000 after rising 421,000 in January and 285,000 in December, the widely-watched unemployment rate shot up 0.6 percentage points to 7.3 percent of the work force in February, marking the highest civilian jobless rate since the 7.4 percent posted in January 1985. What is more, total civilian employment in February fell 394,000 after rising 749,000 in the previous month.

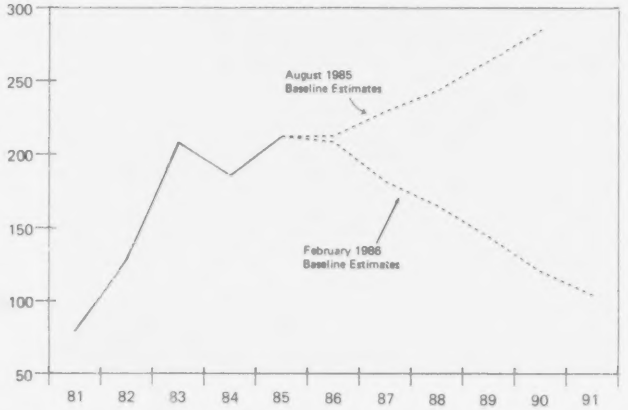
New car sales, stimulated by dealer financing incentives, perked up in February but overall retail sales appear to have been weak both in January and in February. Personal incomes declined 0.1 percent in January, dragging consumption down by 0.4 percent, although both rose strongly in December. The Commerce Department's index of leading economic indicators declined 0.6 percent in January—but it rose faster in December than the government originally thought. There was a solid gain in construction expenditures in January, most of it occurring in residential construction, and the rise in single-family home sales in January coupled with recent declines in mortgage rates, argues for further strength in this sector. Meanwhile, the money supply has been growing rapidly—not only in 1985, but stretching back to 1982 (Chart I).

For all of their declines, interest rates adjusted for inflation are still high compared with historical experience. After subtracting four percent year-over-year inflation from the rate that the commercial banks charge their biggest and best customers, nine percent, one is left with a five percent real rate. This is down from the almost seven percent real rate of ten months ago, but it is still about twice as high as the highest real bank rate posted during the 1970s. The same may be said for long-term rates: a new-issue AA utility bond currently yields about nine percent. When subtracting the rate of inflation, one comes up with a real interest rate that is still well above the highest rate of the 1970s.

In addition, while it is nice to see prices going up at a slow clip, there are many sectors both here and abroad where prices are actually falling. From a consumer's point of view, declining prices may be fine. However, a seller would tend to view falling prices as hazardous to his wealth—an opinion that would no doubt be shared by his banker. When you combine this with the obvious pluses of faster economic growth and the still-high level of real interest rates, you might conclude that further declines in interest rates would seem to be in store. From here, any further downward movement in interest rates in the United States would seem to depend on a variety of developments, among them the next run of economic statistics, what happens to the value of the dollar in foreign exchange markets, the direction of oil prices, and, perhaps most important, the outlook for Washington's budget deficit.

Prospects for reductions in the budget deficit would seem to argue for additional Fed ease to compensate for the tightening up of fiscal policy that a cut in the budget deficit obviously implies. And since easier money tends to require a longer period of time to affect the economy than fiscal restraint, proponents of further monetary ease are suggesting that the Fed should waste no time in doing so. On the other hand, a Federal court recently declared a key portion of the Gramm-Rudman-Hollings Deficit Reduction Act unconstitutional, and if the Supreme Court upholds this decision, it could call into question the Government's long-range plan to eliminate the deficit. At the same time, however, the Congressional Budget Office (CBO) recently came out with a revised prediction for the budget deficit over the balance of this decade which is nothing short of astounding. Instead of ballooning up to nearly $300 billion by 1990, as was projected as recently as last August, the deficit is now expected to fall to $100 billion by 1991—even if no further steps are taken to cut it along the lines of Gramm-Rudman.

CHART II
ACTUAL (LINE) VS. PROJECTED (DOT) FEDERAL BUDGET DEFICIT
(FISCAL YEARS, BILLIONS OF DOLLARS)



Sources: Economic Report of the President; Congressional Budget Office

The Deficit: Changing Minds

When Chairman Volcker said last month that the Congress had taken action to improve prospects for declining Federal deficits in the years ahead, I doubt that he had in mind the astonishing turnabout by the Congressional Budget Office. As recently as last August, CBO was projecting budget deficits rising as far as the eye can see. Chart II shows that CBO projected that the budget deficit by 1990 would reach nearly $300 billion, reaffirming the projection it made six months earlier, in February 1985. For its part, the Office of Management and Budget (OMB), an arm of the

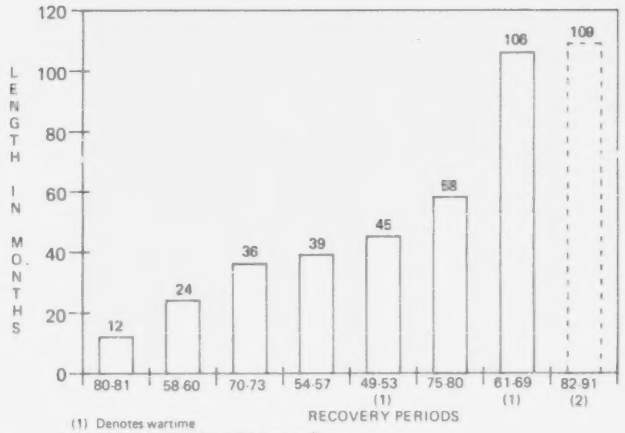
Administration, projected a string of deficits well over $200 billion a year. What is more, since both sets of projections assumed continued economic growth over the balance of a decade—an unprecedented development in postwar peacetime history—alternative projections were made suggesting what could happen to the deficit if a recession were to occur sometime between now and 1990. CBO estimated that such a downturn could push the deficit above $400 billion!

No doubt galvanized by these dire predictions, the Congress in December passed legislation calling for a steady reduction in the budget deficit to the point where it would be eliminated entirely by 1991. Known as the Gramm-Rudman-Hollings Deficit Reduction bill, it was promptly signed into law by President Reagan, in spite of concerns about how much spending would have to be trimmed and/or revenues enhanced in order to meet the law's targets. Congress was told by some economists that this law, by mandating drastic cuts in the Federal budget with the explicit purpose of reducing a string of $200 billion deficits to zero by 1991, would have no rival "save perhaps the infamous Smoot-Hawley tariff of 1929." Others anticipated that by cutting the deficit to zero in six years without offsetting stimulus, the government "would bring the economy to a grinding halt and push the unemployment rate back to double digits in short order."

Just like in the old-time movies, when the heroine was about to be run over by a speeding railroad train, only to be snatched up at the last minute by the Good Guy in the White Hat, along comes the Congressional Budget Office with its revised forecast for the deficit. Instead of projecting $200 billion deficits as far as the eye can see, not to mention its own $300 billion worth of red ink by the end of the decade, CBO now thinks that the deficit will shrink to around $100 billion by 1991—even without the Gramm-Rudman-mandated budget cuts. In view of this, one has to wonder whether Gramm-Rudman would have been passed and signed into law had this been the budget outlook. For that matter, one might question whether the Congress and the President will feel the need to slash the deficit if the Supreme Court, as is widely expected, upholds the lower court ruling on Gramm-Rudman and provides an "out".

To be sure, the difference between last year's long-range budget projections and this year's reflects some substantive developments. Indeed, one is the passage of the Gramm-Rudman law, itself, which has already eaten into Federal spending during the current fiscal year, thus lowering the base for future projections. Another deals with interest costs. Interest rates have come down much faster than either budget agency expected, and the result is $51 billion less interest expense by 1990. Of course, keeping interest rates down assumes that the commands of Gramm-Rudman will be followed—hardly a sure thing. The big reductions are in the defense area. Congress last year made a sizable cut in President Reagan's defense budget which he grudgingly accepted. The end result is a lowering of projected defense outlays by $56 billion in 1990. Nondefense discretionary spending is now projected to be $15 billion lower in 1990. Adding these and other changes together cuts the projected deficit for 1990 by $164.5 billion.

CHART III
COMPARING POSTWAR RECOVERIES



(1) Denotes wartime
(2) Implied by CBO Feb. 1986 Baseline Forecast
Sources: National Bureau of Economic Research; Congressional Budget Office

Notwithstanding these changes which may seem reasonable in light of recent developments, the fact remains that these projections, as did their predecessors, rely on continued economic growth. The economy is expected to expand at a rate of about 3½ percent per year between now and 1991, providing the revenues to help balance the budget. If the economy were to grow this long in peacetime, it would represent a most remarkable achievement. Excluding periods of war, the longest that the U.S. economy has grown nonstop was the 58 months between March 1975 and January 1980 (Chart III). Both CBO and OMB are in effect projecting a peacetime expansion of at least 109 months. To make matters even more astounding, they calculate that the economy can grow without straining available resources of both labor and capital. In other words—they do not look for inflation pressures to heat up, nor for interest rates to rise. You can see where the likelihood of this combination occurring is quite remote.

Thus, in spite of the enactment of the Gramm-Rudman Deficit Reduction Act as well as the brighter projections by CBO and OMB, the deficit outlook is still murky. Even if the Supreme Court doesn't knock the balanced budget legislation for a loop, economic trends just might. It will be most interesting to see how the Federal Reserve Board responds to these challenges in the weeks and months ahead.

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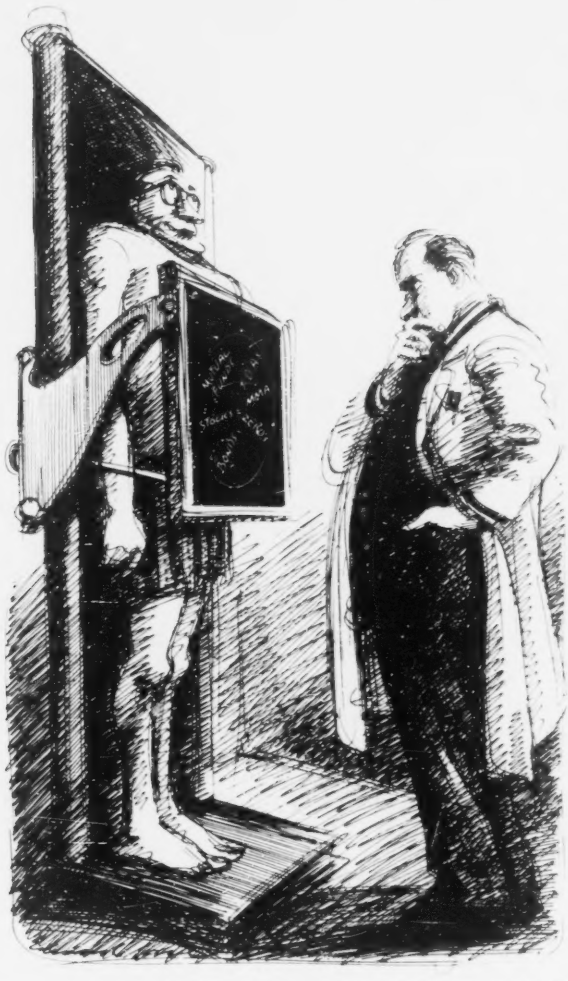

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The Manufacturers Hanover
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Chief Economist

APRIL 1986

Discount Deflation

The recent month-to-month declines in both the producer price index and the consumer price index have given rise to a belief in some quarters that the United States has not only brought inflation to heel—it has actually turned the corner and is now heading down the road toward deflation. As appealing as this may seem from a consumer's point of view (most people would rather pay lower prices than higher prices), generalized deflation could well pose serious problems for many sectors of the U.S. economy.

For sellers, of course, it means decreased revenues and lower profits for those whose prices are falling unless they are able to offset this with increased volume. Declining profits also mean lower tax revenues to the various taxing authorities with the result that they must curtail their services and cut payrolls. And of course, as many farmers and people in the oil business are discovering, lower prices mean that the value of the collateral that may be backing a bank loan has to be reduced, thereby requiring additional collateral which may not always be easy to come by.

If prices fall long enough, many businesses will cease investing because they will not be able to make a profit. Once that happens, joblessness goes up, consumer spending falls and the economy goes into a recession. Needless to say, while debtors have benefitted at the expense of creditors in periods of inflation, the reverse is true when inflation subsides and deflation sets in. The only problem is—the benefit to the creditors is small consolation if the debtors can't pay their debts.

Not to worry. We are a long way from generalized deflation. In fact, I would think that the price declines of the last couple of months are likely to be short-lived, and that rising prices will once more become the order of the day. Not that I am looking for an acceleration of inflation to, let's say, the double-digit range. Rather, I would only suggest that the underlying rate of inflation that has prevailed since the end of the last recession, around four percent, has not changed. This is due to the following four reasons: (1) virtually all of the declines in the producer and the consumer price index have been due to drops in prices of one commodity—oil; (2) most other items in the consumer price index continue to percolate upward in price; (3) the usual tendency for prices at this stage of the business cycle is for them to rise faster, not slower; (4) in this cycle in particular, there are several additional factors which argue for more, rather than less inflation in the months ahead.

Oil Pulls Down The Indexes...

Let's start out with one key observation. The consumer price index does not usually fall when the economy is expanding. Other than a decline in December 1982—one month following the officially-designated end of the last recession—the last time that the consumer price index posted a month-to-month decline when the economy was growing was back in August, 1965. The CPI rose even through the two freezes and four phases of the Nixon Administration's price controls of the early 1970s. Thus, for the consumer price index to fall as it did in February, and again in March, seasonally adjusted, at a time when the economy is generally agreed to be still in the expansion phase of the business cycle, something out of the ordinary has to be at work.

It is. Oil prices have plunged sharply since the end of last year, falling in spot markets by more than 60 percent. A decline of that magnitude in such an important commodity as oil was bound to show up in the price indexes in short order. However, it must be pointed out that petroleum prices represent only a small portion of consumer and producer prices. Furthermore, oil prices are not likely to stay down forever. Indeed, there are good reasons to believe that spot oil prices have already seen their lows. This is based on the combination of a pickup in demand from industrial users responding to oil's more competitive price compared with other sources of power, as well as from consumers, who are buying bigger cars and driving more, the sharp drawdown of inventories which should lead to

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pipeline refilling, as well as the possibility that some agreement to stabilize production might yet evolve. If and as oil prices do move higher, an important lid on inflation will be lifted.

Let us now turn to the rest of the price indexes. Excluding energy, producer prices in March rose at an annual rate of over six percent. Prices of such commodities as aluminum, copper, lumber and platinum are rising rapidly. As for consumer prices, there are many items whose prices in the year ending February were rising about as fast as they were in the previous couple of years—if not faster. For example, in the food category, foods purchased in restaurants are still rising at the same clip that they have been since 1983, while imported foods are going up at the fastest rate since 1980. Housing costs are rising more slowly than they did in 1985 or in 1984, but they are still rising at about the same pace that they did in 1983 and in 1982--the drop in fuel costs notwithstanding.

If you look at the service component of the consumer price index, you will see that it is still rising at above a five percent annual rate. Within that category, medical care services are rising even faster today than they were recently while most other services are rising close to their recent rates (See table).

...But Beneath The Surface...

Turning to the economy in cyclical perspective, Chart I shows you that the usual tendency for the rate of inflation in those business recoveries which lasted beyond three years is for it to accelerate. As you can see from the chart, the current recovery's price performance seems to be paralleling pretty closely the average trend of inflation during three comparable recoveries. Thus if the past alone is any guide, one might expect the rate of inflation to move somewhat higher later on this year, to perhaps a four percent clip.

Of course, there have to be good reasons for expecting a pickup in the rate of inflation—especially in the current context, when the latest readings show the

INFLATION RATES FOR SELECTED CONSUMER SERVICES

	12-Month Percent Change In:						
	Dec. 1980	Dec. 1981	Dec. 1982	Dec. 1983	Dec. 1984	Dec. 1985	Feb. 1986
Home Maintenance Services	10.7	10 5	4.5	7.9	3.3	2.9	4.1
Housekeeping	7.4	10 8	2.6	2.5	2.4	3.8	3.2
Dry Cleaning	12.8	10.8	6.0	5.2	5.2	4.5	4.3
Auto Maintenance	10.9	8.5	6.2	3.8	3.2	3.3	3.1
Medical Care Services	10.3	12.7	11.3	6.2	5.8	6.9	7.3
—Physicians' fees	11.0	11.7	7.5	7.5	6.0	6.9	6.8
—Dentists' fees	10.7	10.2	5.9	8.2	7.5	5.4	5.5
Entertainment Services	8.7	7.3	6.8	5.4	5.7	4.4	3.6
Personal Care Services	8.0	7.5	5.8	3.6	4.9	3.6	4.0
Educational Services	12.4	13.1	12.6	9.9	9.3	7.9	7.9

Source: Bureau of Labor Statistics

CHART I
12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX
CURRENT RECOVERY (LINE), AVG. OF 3 COMPARABLE RECOVERIES (DOT)

Source: Bureau of Labor Statistics

major price indexes heading south. There are. I would say that the main reason why inflation begins to pick up at this stage of a business expansion stems from a fuller utilization of both labor and capacity. Chart II shows you that until recently there was a pretty good relationship between the employment rate (the percentage of the over-16 population at work) and the inflation rate. The rise in the value of the dollar between July 1980 and February 1985 caused this relationship to diverge and that divergence has been continued for now by the fall in oil prices. However, you should not overlook the fact that both employment and the employment rate are in near-record territory, suggesting that many labor markets may be tighter than they look.

This can be seen from a glance at wage settlements. In contrast to the situation that prevailed in early 1983, when virtually no first-year wage increase was negotiated in major collective bargaining settlements, first-year wage increases are now running better than two percent. As a result of this, along with a recent decline in labor productivity, unit labor costs have begun to rise, whereas back at the end of summer, 1983, the four-quarter percent change in unit labor costs was actually negative.

It is difficult to determine why productivity has slowed, thereby helping to push up unit labor costs. Some explanations might include under-investment, too much government regulation, a gradual shift in employment from manufacturing to services along with the difficulty of measuring output in these industries, and earlier efforts to cope with more expensive energy by substituting labor for machinery.

The same disparity may be noted when one compares the rate of capacity utilization in manufacturing with changes in prices, in this instance at the producer or the wholesale level. It is true that capacity utilization is still running close to 80 percent, quite low for the fourth year of a business recovery, and well below the high 80s/low 90s observed during this stage of several previ-

ous business expansions. However, it is also a fact that over the past 15 years, when capacity utilization was at today's rates, inflation was as high as eight percent.

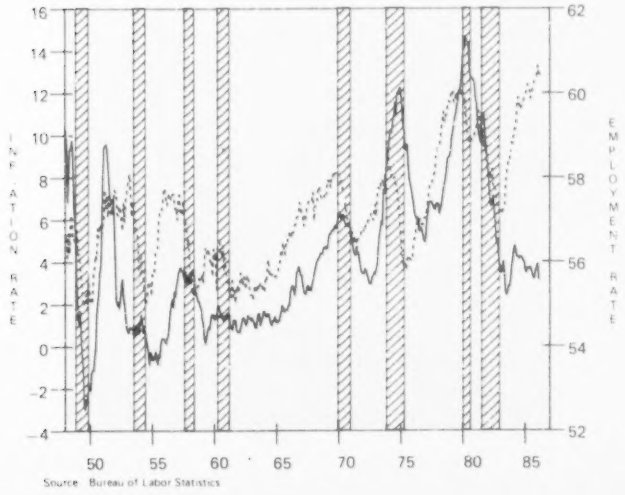
...Price Pressures Persist

Given the relatively low rate of capacity utilization and the fact that there is still over seven percent of the work force unemployed, it might be odd to talk about demand pressures reappearing, thereby driving prices up faster. However, looking at the employment rate, as well as the behavior of many components of the price indexes, we may not be all that far from this development. Certainly, the urge to raise prices has not disappeared with the low rate of inflation. If anything, it has become stronger than ever, since the inability to raise selling prices has cut into many companies' profits and margins.

One indication of how quickly prices are being raised once conditions permit comes from the automobile industry. A major domestic manufacturer recently announced an increase in prices of this year's models of about three percent. This follows a rise in prices of such foreign automobiles as those which come from Japan by close to 15 percent. The rise in prices of Japanese autos, as well as of other Japanese goods in particular and imports in general stems from the steep plunge in the value of the dollar against the yen and many other key currencies. This is already beginning to show up in the price statistics. Chart III shows you that import prices in general turned up toward the end of last year, and since they tend to influence prices of other commodities, it should not be too long before these prices begin to rise more rapidly as well.

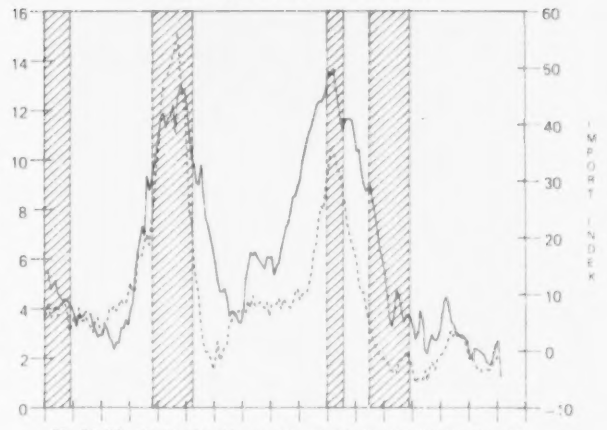
Certainly, one cannot be sanguine about inflation prospects from a look at either monetary or fiscal policy. Since the middle of 1982, the money supply has been growing at better than an 11 percent annual rate. This

CHART II
12-MONTH PERCENT CHANGE IN CPI (LINE)
VS. EMPLOYMENT RATE (DOT)



Source: Bureau of Labor Statistics

CHART III
12 MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX OF COMMODITIES (LINE) AND IN UNIT VALUE INDEX OF IMPORTS (DOT)



Source: Bureau of Labor Statistics, Department of Commerce

has resulted in the creation of an enormous pool of liquidity in the U.S. and elsewhere, and has caused interest rates to decline as the supply of money has outpaced its demand. Those who place great emphasis on the money supply as a predictor of inflation have, of course, been wrong in recent years because of the influence of the earlier strength of the dollar, and more recently, of the decline in oil prices. However, the lower-valued dollar removes one lid on inflation, and if oil prices rise, the other lid will come off, leaving the economy exposed to the excess liquidity that this recent runup in the money supply represents, thus the potential for higher rates of inflation.

If the Federal Reserve had any thoughts of slowing the growth of the money supply to offset these inflationary tendencies, the trend of the government's budget deficit will make it think twice. In the past four years, the deficit has averaged five percent of the gross national product—more than twice as much as it did in the previous four years. Last year's budget deficit was a record-shattering $211.9 billion and this year's promises to be no smaller. This puts the Federal Reserve in a quandary when it comes to monetary policy. The lower-valued dollar by definition means less money is coming into this country available for investment in our financial markets. At the same time, prospects for faster economic growth suggest that the private sector will need to borrow more money this year than last year.

If the Fed wants to keep interest rates down to ensure that this growth will indeed occur, it will have to continue its policy of rapid money growth. With the dollar down, and oil prices likely to go no lower—if not rise—along with the other factors listed above, it is hard to escape the conclusion that we are not on the road to deflation but are traveling the same inflation path we have been on for the last few years. What is more, we had better be watchful that we don't switch to a road that brings even higher inflation in the near future. H

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Economic Report

Irwin L. Kellner
Chief Economist

MAY 1986

The Trouble With Manufacturing

A funny thing happened to our manufacturing sector two years ago, during the early stages of the current economic expansion. After growing faster than average for the first six quarters of the upswing, factory output flattened in the summer of 1984, and has grown very little since. This comes at a time when manufacturing production, on average, tends to rise some 13 percent. Because factory output accounts for more than a fifth of the U.S. gross national product, its slowdown since the middle of 1984 has cast a damper on overall economic growth. Whereas the real GNP grew 10.5 percent during the first six quarters of the current economic expansion, it has only grown 3.1 percent during the most recent six.

An examination of the data as well as conversations with numerous businesspeople, government officials, and others, has produced some rather startling revelations. U.S. manufacturers are being buffeted by a number of developments, most of which are relatively recent, but several of which have been present for quite some time. To make matters even more serious, many of these do not appear to have a solution close at hand.

Competition From Abroad...

What appears to be bothering the nation's manufacturers the most these days is continued inroads of goods made overseas. The latest statistics on our balance of trade indicate that very little improvement took place in the first quarter compared with the fourth, when the nation's trade gap, as measured in the gross national products accounts, hit a record annual rate of over $113 billion. Coming one year after the dollar peaked in the foreign exchange markets and began a slide which took it down more than 30 percent against a basket of currencies of the countries with whom we do most of our trade, one might have expected more of a narrowing in the trade gap, thus more of a boost to domestic output. This makes allowances, of course, for the J curve effect (Economic Report—January 1986), and for the dollar's strength against the Canadian dollar and the Mexican peso.

With some foreign currencies up as much as 55 percent against the dollar over the past 14 months, U.S. manufacturers have been eagerly awaiting a pickup in their business. They may have a long wait. This is because many foreign exporters are not raising prices as much as their currencies have jumped against the dollar. There are many reasons for this, including a wish to retain share of market in the United States and to remain competitive with other countries whose currencies have followed the dollar downward—most important because of lackluster business conditions in many other industrial countries.

Keeping prices down at a time when their currencies have jumped as much as they have against the U.S. dollar obviously implies quite a hit to foreign producers' earnings. So the question logically arises: do these exporters have the earnings capability to withstand the need to raise selling prices? The answer would appear to be affirmative, because of what foreign exporters failed to do during the period July 1980 to February 1985, when their currencies fell dramatically against the U.S. dollar. Most exporters to the U.S. not only did not lower their selling prices to reflect their cheaper currencies in U.S. dollar terms, some even raised them!

Quite clearly, there was a sizable pile-up of profits which are now available to offset the subsequent rise in foreign exporters' currencies. One would imagine that there will come a time when these foreign manufacturers will exhaust their profit cushion and will have to more fully reflect the rise in the value of their currencies against the dollar when pricing their products in the United States. It is impossible to determine when this will occur, but when it does, U.S. manufacturers will have the opportunity to regain some lost business—provided that they don't match these price increases with price hikes of their own.

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...Fewer Autos And Houses...

Another reason why our manufacturing sector has been languishing stems from the performance of the domestic automobile industry, which accounts for over six percent of factory production. Output of U.S.-made cars peaked back in 1973 at 9.7 million units. They subsequently went on a rollercoaster, dropping as low as 5.8 million units in 1982 before recovering somewhat. However, in recent months output has been averaging barely eight million units at an annual rate. This alone has affected the fortunes of a wide variety of industries such as steel, aluminum, copper, rubber, and glass, to name a few. The steel industry in particular has been affected by other factors besides the reduced number of cars made in the United States. First, the total weight of U.S.-produced automobiles has been shrinking since the mid 1970s. The average car has shed 573 pounds since 1976. What is more, 495 pounds of this, or 87 percent was steel.

The shrinking market for steel's use in automobiles typifies what the steel industry faces worldwide. According to the American Iron and Steel Institute, world production of raw steel in 1984 totaled 782.2 million tons—8.2 million tons below 1980's level and only 36.6 million tons greater than output in 1976. To make matters worse, the share of world production coming from the United States shrank from 17.2 percent in 1976 to only 11.8 percent in 1984.

The U.S. is not alone among industrialized countries in losing share of the steel market. Along with the U.S., output from Canada, Japan, the European Economic Community, and other Western European countries declined from 59.3 percent in 1976 to 50.9 percent in 1984. The big gainers during this time were the developing countries. Brazil has seen its share of steel output go from 1.4 percent in 1976 to 2.6 percent in 1984, while South Korea's share has jumped from 0.5 percent to 1.8 percent. China's contribution went from 3.1 percent in 1976 to 6.1 percent in 1984.

Steel and autos are not the only industries dragging down the manufacturing sector. Many products—either finished goods or components—are no longer made in the United States, but rather, abroad. The chief attraction, besides exchange rates, are low wage costs. This is affecting not only U.S. manufacturers, but producers abroad as well. While Japan, for example, may be picking up market share in the automobile, camera, and consumer electronics industries, they're also losing business in the low-price end of these lines to such countries as Korea, Yugoslavia, and Taiwan. As developing countries gain technological skills, they are increasingly able to produce goods either destined for business use or for consumers since their wage costs remain below those of the more industrialized nations.

...And Reduced Demand For Capital Goods...

If this were not enough, U.S. producers have to contend with a marked change in the capital goods industry. Although rising more than nine percent in 1985, business spending on equipment took a header in early 1986, falling nearly four percent in the first quarter alone. Three factors are at work here. First, capacity utilization remains low. Three and a half years into the current business upswing finds the factory operating rate below 80 percent—the first time this has happened in any postwar expansion that has lasted this long. Second, businessmen's appetites for capital goods have been dampened by tax reform legislation.

The bill passed by the House of Representatives last year would repeal the investment tax credit and sharply restrict the Accelerated Cost Recovery System which allows fast writeoffs. The Senate Finance Committee's version passed early in May would also repeal the investment tax credit although it would retain the ACRS with faster writeoffs except for real estate. Changes in these provisions alone would cost business up to $150 billion per year, and, according to the U.S. Chamber of Commerce, would raise the cost of capital to a company by three percent for three-year equipment and six percent for equipment with a useful life of five years or more. With this sword of Damocles hanging over its head, business has hardly been in the mood to invest in capital goods.

Third, the collapse in oil prices has caused the petroleum sector, which accounts for 9½ percent of total industrial output, to cut back its spending on equipment. This is not surprising when you consider the sharp drop in exploratory drilling, among other things. The petroleum industry alone has slashed projected capital goods outlays for 1986 by $6 billion, or over one-fourth, compared with plans formulated late last year. It would seem that the cutbacks are affecting such oil field equipment as drilling rigs, pipelines, metal containers, industrial machines, motor vehicles—not to mention paper and packaging, chemicals, cleaning solvents, and stone and clay products, most of which are made in the U.S.

This is hurting U.S. manufacturers of capital goods, to be sure. Also hurting them is the fact that they are garnering a smaller share of the capital goods market. In 1965, only 3.3 percent of capital goods bought in the U.S. were imports, according to the Commerce Department. As recently as 1970, imports' share was six percent. However, the combination of the 1980-85 rise in the value of the dollar along with technical innovations overseas and lower wage costs, propelled imports' share to nearly 21 percent last year.

Homebuilding is another area that has changed dra-

matically both in recent times as well as longer term. At the moment, housing is being depressed by conditions in the oil patch and in the farm belt. Multiple dwelling construction has also been affected by concerns over tax reform. The National Association of Home Builders estimates that the Senate Finance Committee's bill would result in a loss of about 400,000 housing starts next year.

Considering that new-home construction is no higher today than it was in 1970, you can see where producers of building materials, home furnishings, etc., have seen their markets stagnate. Add to this the fact that the size of the average home has declined by 127 square feet, or 7½ percent in the last four years alone, and you can see a further diminution in the need for building materials. Not only are single-family houses getting smaller, but multi-unit housing, whose living spaces tend to be less than single-family units, have grown as a proportion of total starts. In 1975, multiple family dwellings accounted for less than one out of every four housing units constructed; last year they reached 40 percent.

...Has Depressed Manufacturing

The commercial end of the real estate market has its problems, too, which impact on manufacturing. The office building boom is apparently over, as demand for office space has fallen precipitously. This comes at a time when commercial builders have put up office buildings at a rapid pace, encouraged by generous tax benefits. Office vacancy rates in most major cities have climbed dramatically in the past few years in response to overbuilding in general, as well as to depressed conditions in the oil patch. Needless to say, this has taken its toll.

Spending on business structures accounts for 4¼ percent of the gross national product, up from 3.6 percent in 1978. Construction of factories and office buildings, warehouses and shopping centers uses up a major chunk of the output of stone, clay and glass, fabricated metals, not to mention a host of other materials, a lot of which is produced in the United States. Outlays for nonresidential structures flattened in the first quarter of 1986 compared with the fourth quarter of 1985. If they do no more than hold steady (and they seem more likely to decline), business spending on structures will rise two percent this year following a jump of over 15 percent in 1985.

Last on the list is agriculture. Depressed conditions down on the farm have caused considerable cutbacks in farmers' purchases of farm machinery, much of which is produced in the United States. Needless to say, they are also buying fewer consumer goods, especially those that are postponable, such as automobiles, furniture and home appliances—again the bulk of which is made in the United States.

As you can see, the nation's manufacturing sector has many problems. Some should diminish in the near future. For example, as foreigners use up their profit cushions and raise selling prices in the U.S., domestic manufacturers will have an opportunity to reclaim their share of market. Oil prices look like they've seen their lows, and if they go up further, some capital spending projects by the important petroleum sector may be restored. And once tax reform is either killed or becomes law, there could be some pickup in capital goods spending since the uncertainties surrounding the exact tax treatment of such outlays will no doubt have been clarified. As for agriculture, farm commodities prices have already bounced up in the wake of the Soviet nuclear disaster, and if they rise further, will boost farm incomes, thus, farmers' buying power.

These are about the brightest spots one can find and they are none too bright. The dark clouds are still present. There doesn't seem to be any letup in the inroads made by foreign automakers in our domestic automobile market. At the same time, U.S. cars will continue to remain small and use less steel than their predecessors. The newly industrializing countries will continue to produce more and more of the goods that used to come mainly from the industrialized world, thanks to the spread of technology and to their lower labor costs. The real estate market does not appear likely to be a major contributor to the manufacturing sector for some time to come.

Some Bright Spots

However, all is not bleak. The fact that the manufacturing sector today accounts for the same share of national output that it did 35 years ago indicates that the U.S. is not deindustrializing as some would maintain. We are not any more of a service economy than we were in the early 1950s. What is happening is that production is shifting—from commodity-type, to high value-added products.

U.S. manufacturers will be able to remain in business if they concentrate on producing goods which require either complicated labor skills and/or high levels of capital investment. The U.S. needs a manufacturing sector in order to be more productive. Since the start of this decade alone output per hour worked in manufacturing industries has jumped by nearly 21 percent, or almost five times that of the economy as a whole. This is not a sign of a dying sector but rather, of a healthy one. This health will become more evident once the temporary problems weighing it down diminish and the longer-term problems are dealt with through technological change, legislation, or economic growth. Until then, we will continue to witness a divergence between factory output and overall GNP growth. H

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- Proceeds help support the following area hospitals: United, Lawrence Auxiliary, New Rochelle, Northern Westchester, Phelps Memorial, St. Agnes, St. John's, St. Joseph's, St. Vincent's, Blythedale Children's, Greenwich, Mount Vernon, White Plains, Yonkers General.
- Tickets on sale at all these hospitals through June 1st, thereafter at the gate. To charge with MasterCard or VISA, call 212-808-8519, Monday to Friday, 9am-5pm.
- For more information call (914) 967-5356.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

JUNE 1986

Business Conditions Update

Change is in the wind. After two years of sluggish growth, the U.S. economy seems to be on the verge of a pickup. The gross national product adjusted for inflation could very well rise at a four percent annual rate in the next twelve months—about twice as fast as the two percent pace it posted during the past two years. Because of this, among other factors, there is a change in the outlook for inflation. Deflation, or falling prices, is now a thing of the past and in its place have reappeared rising prices, or inflation. The financial markets have already reacted to these changes. In anticipation of an improving economy accompanied by rising prices, along with a change in Federal Reserve monetary policy, interest rates have stopped falling and are up from their lows reached earlier this year.

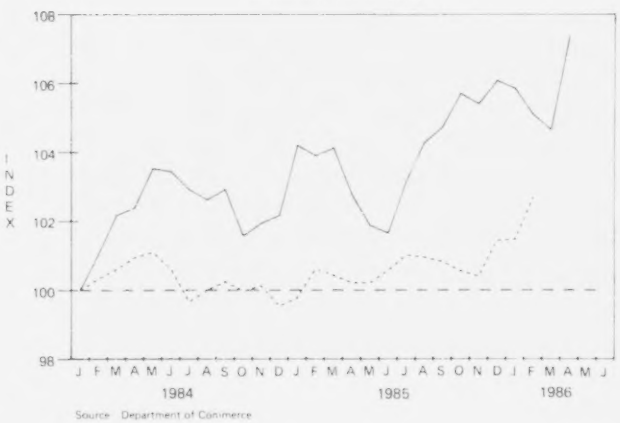
Faster Growth Is On Tap ...

Some of these changes will be evident when the second quarter's data are released in July. Although the real GNP's growth rate will probably be less than that of the first quarter, in many respects, the second quarter should look a lot better than the first (see table inside). For one thing, less of the rise in GNP will reflect an increase in business inventories. Indeed, it would appear that there was a sharp cutback in the rate of business inventory accumulation in the second quarter compared with the first, when there was a big increase. This was one of the main reasons why the top-line GNP figure grew more slowly in the second quarter than it did in the first. However, beneath the surface, things are somewhat brighter, since sales to final consumers appear to have picked up, in contrast to the decline posted in the first quarter. Finally, the decline in our trade deficit—although slight—nonetheless suggests that more of what was purchased by consumers, business and governments was made in the United States, rather than overseas.

I noted back in the February Economic Report that there were a number of developments which had already occurred that made us hopeful. Let me repeat these briefly along with their implications:

- The foreign exchange value of the dollar has fallen by nearly 30 percent since the end of February, 1985. This has stemmed the rise in our trade deficit—a major drag on economic growth.

LEADING ECONOMIC INDICATORS:
FINANCIAL (LINE) VS. NONFINANCIAL (DOT) COMPONENTS
(JANUARY 1984=100)



Source: Department of Commerce

- Growth in the money supply in 1985 was the fastest for any year in postwar history and appears to have accelerated during the first half of 1986. This caused a sharp decline in interest rates, making it easier for people and for businesses to borrow in order to make big-ticket purchases.
- Employment has grown much faster than usual in this business expansion and is now at a record level in terms of the number of people at work, and close

NO REPORTS IN SUMMER

The Economic Report will not be published during July and August. The next issue will appear in September.

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to a record when compared with the over-sixteen population. This has enhanced buying power and confidence.

- The stock market has jumped by nearly 40 percent since last September and is more than twice the level touched back in August 1982. This has added more than $1 trillion to the value of stocks, an amount equal to 28 percent of the gross national product or nearly $5,000 for every man, woman and child in the United States. This has bolstered the buying power of investors in particular, and confidence among the populace at large.
- Oil prices in spot markets have plunged precipitiously since last autumn, falling at one point by as much as two-thirds. This has also added to buying power and caused inflation to be stopped dead in its tracks.

Notwithstanding these facts and their positive implications, some people remain skeptical about the near-term prospects for the U.S. economy. To be sure, few would say that we are on the verge of, or are already in, a recession. However, the plethora of mixed statistics that have come out in recent months has made some skeptical of the imminence of an economic rebound. It is easy to be distracted by the negative numbers when one is looking for a positive outcome. Let us not forget that there are a few positive statistics out there—some of which are visible and some of which are obscured.

... Spurred By Housing and Consumers

The most visible is housing. Thanks to rising personal incomes, relatively stable home prices and steep declines in mortgage interest rates, housing is on a roll. The number of new single-family homes sold in the March-April period rose to a record 878,000 units at a seasonally adjusted annual rate, surpassing the previous two-month record set back in May-June 1978. Although new-home construction shot up 12 percent in the first quarter compared with the fourth, it was not enough to keep up with the sizzling selling pace. The net result is that the inventory of unsold new homes now measures only 4.7 months at recent selling rates—the lowest level in almost 15 years. With the number of households planning to buy a home the highest since 1978, many are turning to resales. Existing single-family home sales topped 3.5 million units at a seasonally adjusted annual rate at last count—the highest reading since late 1979.

As housing goes so go many other industries. The ripples from the housing boom have benefited manufacturers of such construction materials as lumber, gypsum, roofing and glass. Homebuilding also aids those manufacturers who produce finished products including major appliances, cabinets, and bathroom fixtures, to name a few. The Association of Home Appliance Manufacturers estimates that in April, 3.7 million major household appliances were shipped, establishing a new record for the month. And the Conference Board reports that the number of consumers planning to buy a new major appliance in the next half-year has been running at a strong pace for several months.

Not surprisingly, consumer spending in general continues to grow—although you wouldn't know it from a glance at the latest retail sales figures. Retail sales in May fell 0.1 percent following a rise of only four-tenths of one percent in April and a drop of four-tenths of one percent in March. However, there is more to this than meets the eye. For one thing, there was a 2.8 percent jump in sales of furniture and home furnishings—an important category, since it consists of big-ticket items. For another, the overall sales figures are not adjusted for price changes.

In real terms, retail sales are doing better than the nominal, or dollar figures would suggest. This is because prices of most items at retail are either stable or falling. Calculations by this Bank indicate that real retail sales in April and May averaged 1.6 percent higher than in the first quarter. Even if June's sales are no higher than this two-month average, the annual rate of increase for the second quarter will be 6½ percent.

June, 1986
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3917.5	3960.6	4016.9	4059.3	3988.6	5.7	4115.7	4159.8	4225.2	4290.6	4197.8	5.2
GNP: $82	3547.8	3557.4	3584.1	3590.8	3570.0	2.2	3616.9	3635.0	3670.9	3705.2	3657.0	2.4
% Change, Annual Rates	3.7	1.1	3.0	0.7	2.2		2.9	2.0	4.0	3.8	2.4	
Consumption	2525.0	2563.3	2606.1	2634.8	2682.3	6.6	2668.2	2702.3	2740.2	2760.3	2717.8	5.2
Durables	351.5	356.5	376.0	362.0	361.5	9.2	363.1	373.2	381.9	389.6	376.9	4.3
Non-Durables	895.7	910.2	914.5	928.3	912.2	4.6	935.6	931.1	941.0	948.2	939.0	2.9
Services	1277.8	1296.6	1315.6	1344.6	1308.6	7.3	1369.5	1397.9	1417.3	1422.6	1401.8	7.1
Investment	657.6	672.8	666.1	680.7	669.3	−0.7	717.2	705.3	719.7	735.9	719.8	7.5
Non-Residential	459.6	474.2	478.5	492.5	476.2	11.3	479.1	480.6	485.2	492.3	484.3	1.7
Producers Durable Equipment	293.5	304.5	308.1	318.0	306.0	9.2	309.9	311.2	316.6	325.2	315.7	3.2
Structures	166.1	169.7	170.4	174.5	170.2	15.3	169.1	169.4	168.7	167.1	168.6	−0.9
Residential	179.4	183.1	187.4	192.5	185.6	3.6	198.2	210.6	220.2	227.3	214.1	15.3
Inventory Changes	18.5	15.5	0.2	−4.3	7.5		39.9	14.2	14.2	17.3	21.4	
Net Exports	−42.3	−70.3	−87.8	−113.4	−78.5		−105.8	−89.0	−90.8	−90.7	−94.1	
Government Purchases	777.2	794.8	832.5	857.2	815.4	10.7	836.2	847.2	856.1	859.4	849.7	4.2
Federal Defense	249.5	256.0	269.9	272.1	261.9	10.5	268.0	270.4	272.5	274.1	271.2	3.6
Federal Civilian	84.9	81.7	95.0	112.6	93.5	23.1	89.1	90.6	90.2	87.6	89.4	−4.4
State & Local	442.8	457.1	467.7	472.5	460.0	8.5	479.0	486.2	493.3	497.7	489.1	6.3
Final Sales: $82	3532.0	3542.3	3585.8	3597.1	3564.3	3.9	3581.6	3621.4	3657.2	3688.7	3637.8	2.1
% Change, Annual Rates	6.2	1.2	5.0	1.3	3.9		−1.7	4.2	4.0	3.5	2.1	
Domestic Demand: $82	3619.6	3658.5	3703.9	3731.6	3678.4	2.8	3747.2	3764.0	3796.6	3819.4	3781.8	2.8
% Change, Annual Rates	0.4	4.4	5.1	3.0	2.8		1.7	1.8	3.5	2.4	2.8	
GNP Price Index (1982 = 100)	110.4	111.3	112.1	113.0	111.7	3.3	113.8	114.4	115.1	115.8	114.8	2.8
% Change, Annual Rates	3.0	3.3	2.9	3.3	3.3		2.9	2.1	2.5	2.6	2.8	
Consumer Price Index (1967 = 100)	317.9	321.0	323.1	326.5	322.1	3.5	327.7	326.6	329.1	332.0	328.8	2.1
% Change, Annual Rates	3.2	4.0	2.6	4.3	3.5		1.4	−1.3	3.1	3.6	2.1	
Total Personal Income	3240.9	3280.1	3298.5	3354.3	3293.5	5.8	3397.5	3442.9	3487.5	3493.7	3455.4	4.9
Disposable Personal Income	2739.2	2817.7	2800.2	2845.9	2800.8	4.9	2893.4	2934.8	2967.0	2972.2	2941.8	5.0
Savings Rate	4.8	5.9	3.7	4.0	4.6		4.4	4.6	4.1	3.2	4.1	
Unemployment Rate	7.3	7.3	7.2	7.0	7.2		7.1	7.2	6.9	6.8	7.0	
Indus. Production (1977 = 100)	123.8	124.2	124.8	125.4	124.5	2.3	125.6	124.7	125.9	127.8	126.0	1.2
Housing Starts (000)	1761.7	1742.7	1687.7	1773.3	1741.3	−1.2	1998.3	1975.7	2013.3	2105.2	2023.1	16.2
Domestic Auto Sales (000)	8454.7	8239.0	9440.3	6996.3	8282.6	4.2	7884.3	8117.0	7861.0	7905.1	7941.8	−4.1
Corporate Pre-Tax Profits	220.0	218.7	228.6	233.8	225.3	−5.2	216.6	228.9	240.8	243.7	232.5	3.2
− Taxes	83.4	82.3	87.4	87.1	85.0		79.7	80.1	89.1	92.6	85.4	
Net Profits	136.6	136.4	141.1	146.7	140.2	−2.6	137.0	148.8	151.7	151.1	147.1	5.0
− Dividend Payments	82.0	83.1	83.9	85.0	83.5	6.9	87.6	99.7	101.6	101.2	97.5	14.7
Undistributed Profits	54.6	53.3	57.3	61.7	57.7	−13.9	49.4	49.1	50.1	49.9	49.6	−12.5
+ Depreciation	325.4	334.0	346.8	354.2	340.1		356.2	360.3	364.7	368.4	362.4	
− Inventory Profits	−0.7	−2.2	−4.7	10.1	0.6		−18.0	−27.2	−6.6	10.0	−10.4	
Net Cash Flow	380.7	389.5	408.8	405.8	396.2	10.6	423.6	436.6	421.4	408.3	422.5	6.6

In the first quarter, real retail sales grew at an annual rate of 4¾ percent compared with last year's fourth quarter. Thus consumer spending, the mainstay of the economy, is still rising, and seems to be providing the underpinnings for a return to growth in real final sales in the second quarter, as well as later on this year, since employment continues to expand.

Turning to foreign trade, it would appear that the trade deficit has hit a peak and is now declining. Both in the gross national product accounts as well as in other measures, the deficit in our balance of trade is shrinking. The drop in the trade deficit in the first quarter compared with the fourth helped boost the first quarter's GNP: Domestic demand grew more slowly in the first quarter than it did in the fourth. Since last September, exports adjusted for higher prices have risen by more than five percent or an annual rate of nearly nine percent. By contrast, real imports have declined by 4½ percent, or an annual rate of nearly eight percent.

Looking ahead, the government's measure of statistics that tend to change direction ahead of the economy is climbing noticeably. The Commerce Department's index of leading economic indicators has jumped by an average of more than one percent a month in the last three months—with the April increase the best in 2½ years. Even more significant—for the first time in two years, those components which measure the production sector are rising, in contrast to earlier months, when the bulk of the increases was centered mainly among those indicators that track the financial sector (see chart on page 1).

Inflation Is Back ...

As for the price situation, it would appear that the days of deflation have ended. The April Economic Report warned that earlier declines in prices at the consumer and at the producer level were due mainly to falling oil prices. The end of falling oil prices allowed the producer price index in May to pop up by 0.6 percent or a 7.8 percent compounded annual rate. For its part, the consumer price index last month rose after three consecutive monthly declines.

To assess the outlook for inflation, one might want to imagine an inflation balance sheet. On one side are factors that have brought inflation down while on the other are factors which tend to push prices up. Six years ago, in the spring of 1980, consumer prices were rising at a rate of 14 percent, while producer prices were up at a 20 percent clip. Since then, four factors have intervened to turn spiraling inflation into deflation six years later. The first was tight money, instituted by newly-appointed Fed Chairman Paul A. Volcker starting in late 1979. But that ended in the middle of 1982 and has since been replaced by easy money which may

eventually fuel inflation. A recession ensued in first-half 1980 followed by another one starting in August 1981 which didn't end until November 1982. This has obviously ended since we are now in the fourth year of a business expansion. The dollar climbed by 90 percent between July 1980 and February 1985, exerting a downward pull on the price level, but since then the dollar has plunged. Finally, oil prices declined starting last October, but they bottomed out in early April and have since risen a few dollars a barrel.

Looking at those factors pushing prices higher, besides easier money, the weaker dollar, and rising oil prices, we have tightening labor markets as a result of the surge in employment and a shortage of workers with certain skills in some parts of the country. Also, the service component of the consumer price index, which was rising at a five percent clip throughout the period of slowing inflation, is now rising at a seven percent annual rate—and services comprise more than half of the CPI.

While inflation is back, it is not likely to accelerate into the danger zone anytime soon. The best guess is for prices to rise at between a three and four percent annual rate over the balance of this year at the consumer level, and around two percent or so at the producer level. This will not be enough to cause the Federal Reserve to think about tightening money, and, hopefully, will not preclude further declines in rates.

... But Not Enough to Boost Interest Rates

This brings me to the third change and that is in the direction of interest rates. Interest rates in long- and short-term markets had tumbled, with long-term rates falling some three percentage points in less than one year's time while short-term rates dropped by a little over two points. However, a bottom was reached in early spring; since then most interest rates have climbed. Part of this change in direction is due to expectations of faster growth. A pickup in business increases the demand for funds. At the same time a return to inflation might justify higher interest rates. But part of the backup in rates may also trace to a change in Federal Reserve policy.

The Fed no longer seems to be leading the way toward lower interest rates. Rather, it appears to have adopted a neutral policy for the time being, neither pushing rates lower nor encouraging them to rise. However, this change, unlike the previous two, might be temporary. Indeed, if it isn't, then one of the other changes—faster growth—may not occur. This is because, for all their declines, interest rates adjusted for inflation are still high, compared with historical experience. And most economists—not to mention virtually all businessmen—would agree that high real interest rates are hazardous to the economy's health.

Considering the problems still extant in manufacturing, among farmers and developing countries, plus the low rate of inflation and the high rate of unemployment, it is not unreasonable to hope that the Federal Reserve will resume pushing interest rates lower until they reach the right level to rekindle economic growth. A reduction in Washington's budget deficit would help, too. H

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The Manufacturers Hanover
Economic Report

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SEPTEMBER 1986

Why Our Trade Gap Persists

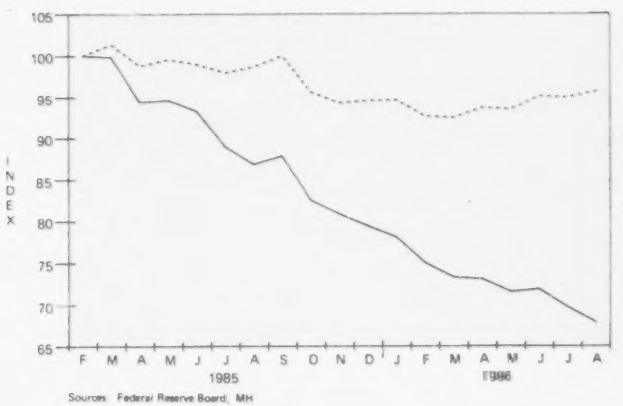
A year and a half has now gone by since the dollar began its monumental slide in the foreign exchange markets. Although it portended higher prices for consumers, this decline was welcomed because it meant that the goods-producing sector would eventually become more competitive with foreign-made products, here and abroad. Washington did more than welcome the dollar's slide—it aided and abetted it. The net result is what appears to be a greater than 30 percent drop in the value of the dollar on a trade-weighted basis.

As this decline got underway, businessmen began gearing up for increased demand while economists both in and out of Washington raised their forecasts for the real gross national product. Both groups based their optimism on the belief that a decline of this magnitude in the foreign exchange value of the dollar would soon divert spending away from foreign-made products, and towards domestically-produced items. This would mean that even if growth in consumption were to slow, an anticipated narrowing of the trade deficit would lead to faster growth in domestic output.

Of course, such a shift was not expected to occur overnight. Thus forecasts of better growth focused on 1986, rather than in the months immediately following the start of the dollar's plunge. As the trade deficit failed to narrow, economists pointed to such factors as the J curve effect (Economic Report—January 1986), suggesting that it takes time before the trade gap of a country with a declining currency stops expanding and begins to shrink. As the deficit continued to widen, other explanations were offered, such as the belief that exporters in some countries were not raising their prices by as much as their currencies rose against the dollar in order to retain market share in the United States and elsewhere.

The next issue will appear in November.

CHART I
TRADE-WEIGHTED DOLLAR EXCHANGE RATE:
FEDERAL RESERVE (LINE) VS. MHT (DOT)
(FEBRUARY 1985=100)



Sources: Federal Reserve Board, MH

These explanations are probably accurate as far as they go. However, they overlook an important aspect of the dollar's behavior. This is the fact that it has not fallen uniformly against all currencies. Rather, the dollar has dropped sharply against a few, held steady against others—and actually risen against some. The informed reader would question the significance of this revelation, since most measures of the trade-weighted dollar show a substantial decline in its value since February 1985. We would respond by saying that of all the explanations offered for the failure of the trade gap to narrow in response to the lower-valued dollar, the fact that the dollar has not declined uniformly may well turn out to be one of the most important.

The Trade-Weighted Dollar...

It would appear that a new calculation of the trade-weighted dollar is called for. This is because the Federal Reserve's index, for one, does not seem to be painting a realistic picture of what has happened to the dollar with respect to the currencies of our most important trading partners. For one thing, the currencies in the Fed's index belong to those countries whose total worldwide trade—not just trade with the United States—was the largest in the years 1972 to 1976. The weight of each foreign currency in the index is the ratio

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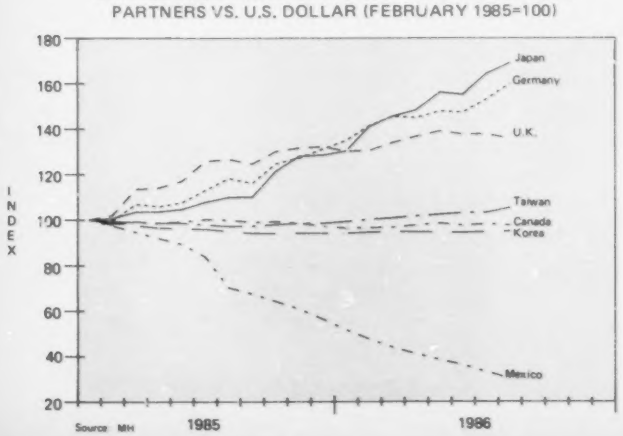
of that country's worldwide exports plus imports to the worldwide exports plus imports of the ten largest trading countries during those years. Thus the German mark has the largest weight in the Fed's index.

However, in order to measure the potential impact of the dollar's depreciation in foreign exchange markets on our trade performance, a trade-weighted index should include the currencies of those countries whose trade is currently most important to the United States. This is especially true nowadays, since the countries whose currencies have increased against the dollar over the past 18 months are chiefly the industrial countries of Europe and Japan. The dollar has declined by an average of 34½ percent against the currencies of these countries—but they only account for 38½ percent of our trade (see table). To get a truer picture of the trade-weighted value of the dollar, it is necessary to take into account—and give proper weight to—the currencies of a number of other countries. For of the nearly $110 billion deterioration in the U.S. trade deficit between 1981 and 1985, around one-half was with Canada, Latin America, and the newly industrializing countries (NICs) of Southeast Asia.

Constructing an index based on the currencies of our 17 largest trading partners in 1985 weighted by their share of U.S. trade (exports plus imports), reveals that the dollar has actually declined by little more than four percent from its February 1985 peak (Chart I). What is more, as the table reveals, if you take the currencies of our top seven trading partners alone—which, by the way, account for 61 percent of our trade and 75 percent of our deficit—you will find that the dollar has *risen* by an average of over 11 percent since February 1985 (Chart II). And if you focus on just six of our 17 major trading partners (Canada, Mexico, Taiwan, Korea, Hong Kong and Brazil) which account for 35 percent of both our trade and of our deficit, you will see, astoundingly, that the dollar has jumped by an average of 71 percent since February 1985!

CHART II
CHANGE IN CURRENCIES OF TOP SEVEN U.S. TRADING PARTNERS VS. U.S. DOLLAR (FEBRUARY 1985=100)



In comparing the Federal Reserve's trade-weighted dollar with the Manufacturers Hanover trade-weighted dollar, several observations stand out:

- The Fed's index is based on trading patterns of the mid-1970s, whereas ours is based on last year's.
- The ten countries included in the Fed's index accounted for little more than half (57.8 percent) of total U.S. trade in 1985, whereas this country's 17 largest trading partners whose currencies are included in our index, accounted for nearly four-fifths (78.3 percent) of total U.S. trade last year.
- The U.S. dollar has depreciated against every currency in the Fed's index except the Canadian dollar, against which the U.S. currency has appreciated slightly. However, the U.S. dollar has risen against the currencies of six of our 17 largest trading partners while remaining unchanged against two others.
- While the mark is the most heavily weighted currency in the Fed's index, Germany's share of U.S. trade in 1985 was only 5.3 percent, about the same as the 5.2 percent figure in 1975. Germany in 1985 was only our fourth largest trading partner so an index that gives the mark the heaviest weight is not a true representation of U.S. trade patterns.
- The Fed's index completely excludes the newly industrializing countries (NICs) of Southeast Asia—Taiwan, South Korea, Hong Kong and Singapore. The omission of these countries is striking, since this area represents one of the fastest growing components of U.S. trade in recent years. Our trade with these countries has increased from $11 billion in 1975 to an annual rate of nearly $65 billion so far this year, while our trade deficit with these countries has soared from less than $500 million in 1975 to an annual rate of nearly $29 billion.
- Another area of the world where U.S. trade patterns have changed dramatically since the Federal Reserve's index was created in the mid-1970s is Latin America. Of this country's 17 largest trading partners whose currencies are included in the Manufacturers Hanover trade-weighted dollar index, three are from Latin America: Mexico (our fourth largest trading partner this year), Brazil (our 12th largest) and Venezuela (our 14th largest). As the table indicates, we are running trade deficits with all three. None of these countries' currencies is included in the Fed's index.
- The Fed's index includes the currencies of Sweden and Switzerland, which are not in the Manufacturers Hanover index. However, together, these two countries accounted for only two percent of U.S. trade in 1985.

COUNTRIES INCLUDED IN MANUFACTURERS HANOVER'S TRADE-WEIGHTED DOLLAR INDEX

Ranked by Importance to U.S. Total Trade (Exports Plus Imports)

U.S. Deficits (−) Surpluses (+)

Country	January-July 1986 U.S. Total Trade ($ bil.)	Percent of U.S. Total Trade	Cumulative Percent of U.S. Total Trade	January-July 1986 U.S. Trade Balance ($ bil.)	Percent of U.S. Total Deficit	Percentage Change in the U.S. Dollar from Feb '85 to Aug '86 Against the Currencies of:
Canada[1]	66.7	18.9	18.9	−14.1	13.8	2.6
Japan[1]	66.2	18.7	37.6	−34.2	33.5	−40.8
Germany[1]	21.0	5.9	43.5	−9.4	9.2	−37.4
Mexico	18.0	5.1	48.6	−3.2	3.1	231.7
U.K.[1]	16.1	4.5	53.1	−2.8	2.7	−26.2
Taiwan	14.7	4.2	57.3	−8.7	8.5	−4.9
South Korea	11.2	3.2	60.5	−3.9	3.8	5.6
France[1]	10.7	3.0	63.5	−2.3	2.3	−33.3
Italy[1]	9.6	2.7	66.2	−3.9	3.8	−30.1
Netherlands[1]	7.1	2.0	68.2	+1.8	−1.8	−37.7
Hong Kong	6.8	1.9	70.1	−3.4	3.3	0.0
Brazil	6.4	1.8	71.9	−2.6	2.5	267.7
Belgium-Luxembourg[1]	5.7	1.6	73.5	+0.5	−0.5	−35.5
Venezuela	5.2	1.5	75.0	−1.5	1.5	0.0
China	4.9	1.4	76.4	−0.9	0.9	31.1
Australia	4.8	1.4	77.8	+1.5	−1.5	21.0
Singapore	4.7	1.3	79.1	−0.8	0.8	−4.3
Others[2]	73.8	20.9	100.0	−14.1	13.8	—
Total	353.6	100.0	—	−102.0	100.0	—

Sources: IMF; Dept. of Commerce; MH

[1]Contained in the Federal Reserve's trade-weighted dollar index, along with Sweden and Switzerland.
[2]Not included in MH trade-weighted index.

...Has Not Declined As Much...

As you can see from the table, Canada is now our largest trading partner, acounting for nearly 19 percent of U.S. trade so far this year. In an almost $120 billion annual two-way trade, it is the world's largest bilateral relationship. Canada is our top export market, taking over 22 percent of our foreign sales in 1985. We sell more to Canada than to the entire European common market, more to the province of Ontario than to Japan. However, the U.S. trade deficit with Canada has grown rapidly over the past decade, widening from $1 billion in 1975, to $7.2 billion in 1981, to $22 billion in 1985, second only to Japan. So far this year, the deficit is running at more than a $24 billion annual rate. Thus it is inaccurate to assign Canada fifth place, as the Fed's index does.

While declining against the currencies of the other industrialized countries, the U.S. dollar has advanced by nearly three percent against its Canadian counterpart since February 1985, bringing the total U.S. dollar appreciation against the Canadian dollar since July 1980 to 20½ percent. In view of this exchange rate movement, the reason for the rapid growth of our trade deficit with Canada becomes obvious. U.S. companies have found it increasingly difficult to challenge their Canadian competitors on the basis of price.

Turning to another area, a close examination will reveal the growing importance of the newly-industrializing countries of the Pacific Basin to U.S. trade. As you can see from the table, two of our five largest deficit positions are with NICs from this part of the world—Taiwan and Korea—while with Hong Kong we posted our seventh largest trading deficit. This contrasts sharply with the trade situation in 1975, when the U.S. ran surpluses with Korea and Singapore, and only modest deficits with Taiwan and Hong Kong.

The currencies of these NICs are closely linked to the dollar, so the decline in the U.S. currency against the currencies of the industrial countries has done very little to improve our trade competitiveness with them. Since 1979, the Taiwan dollar has been tied to a basket of currencies whose largest weight is the U.S. dollar. The U.S. dollar has depreciated by less than five percent against the Taiwan dollar since February 1985. On the other hand, the South Korean won is also linked to the dollar—but since February 1985 the dollar has actually risen by 5½ percent. The Singapore dollar, likewise, is tied to the U.S. dollar, but it has been allowed to rise against its U.S. counterpart since February 1985. As for Hong Kong, in October 1983 the government adopted a fixed exchange rate policy, pegging the Hong Kong dollar to the U.S. dollar at 7.8/$. Thus there has been no change in the relationship of the U.S. dollar to the Hong Kong dollar since February 1985.

These Southeast Asian NICs have managed to score major trade gains as a result of tying their currencies to the U.S. dollar. And of course, since their currencies have also depreciated against the Japanese yen, these NICs have made major inroads into Japan's export markets both in the U.S. and elsewhere. Besides their exchange rate policies, low labor costs have given these NICs a competitive edge over their U.S. counterparts. In addition, because of rapid developments in technology, these NICs have diversified from low-priced consumer goods to more sophisticated manufactured goods. Thus as the costly yen squeezes Japanese goods out of the U.S. market, the NICs are moving in. It could well be that once our trade picture with Japan finally improves, it will be offset by worsening deficits with the newly industrializing countries of Southeast Asia, giving little relief to our beleaguered manufacturing sector.

Until the developing country debt crisis made the front pages, Latin America was a major growth market for U.S. goods. Now it's no longer the case. Prior to 1982, economic growth was the chief priority of most Latin American countries. Policies implemented to achieve this objective had an extremely favorable impact on the U.S. trade balance during the 1970s and the early part

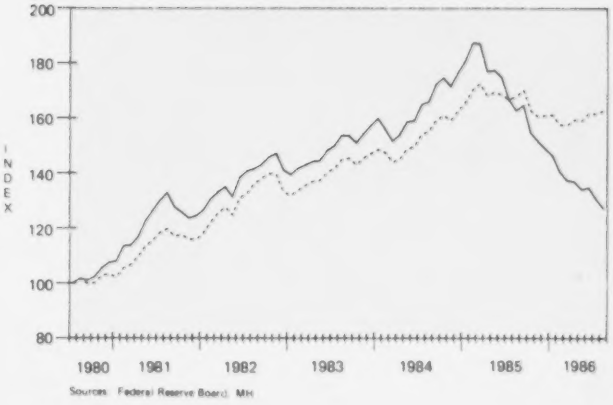
of this decade. Latin American development plans led to heavy imports of U.S.-produced capital goods, while rapid economic growth in Latin America attracted an influx of consumer goods as well. As a result, the U.S. posted a number of trade surpluses with Latin America, culminating in a $1.3 billion trade surplus in 1981.

All this changed in the next year. The debt crisis of 1982 forced Latin American countries to redefine their priorities and readjust their policies. Earning foreign exchange to meet debt payments became the chief priority of most Latin American nations. Economic policies to achieve this goal had major effects on the U.S.-Latin American trade balance. Export promotion programs and more realistic exchange rate policies caused exports from Latin America to the United States to surge by over 20 percent between 1981 and 1985. At the same time, import restrictions and a recession in Latin America led to a 26 percent plunge in exports from the United States, producing a trade deficit with Latin America of more than $18 billion by last year.

...As Is Generally Believed

It seems pretty clear, to us, at least, that in order to properly analyze and evaluate our trade position worldwide, thus the outlook for the U.S. economy, it is necessary to look at a broader, more up-to-date index of the trade-weighted dollar than the one provided by the Federal Reserve. When you do, you can see perhaps the chief reason why our trade deficit has remained large, and why the industrial sector of the

CHART III
TRADE-WEIGHTED DOLLAR EXCHANGE RATE:
FEDERAL RESERVE (LINE) VS. MHT (DOT)
(JULY 1980=100)



Sources: Federal Reserve Board; MH

U.S. economy remains in low gear. As Chart III shows, the Fed's trade-weighted dollar may be back down to 1981 levels—but ours is still as strong as it was two years ago, and remains 63 percent above July 1980. Therefore, it would seem that for the U.S. trade gap to narrow significantly, the dollar will not only have to fall further against those currencies where it has already declined—it must also drop against at least some of those currencies where until now it has either been stable or still rising. H

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